Inflation Matters: Targets & Types – What can monetary policy do?

Anis Chowdhury
Senior Economic Affairs Officer
Office of the Under-Secretary-General
UN-DESA, New York

DESA-ESCAP-Bangladesh Bank Regional Training Workshop on
Beyond Inflation Targets: Policy Options and Instruments for Sustaining Growth and Equitable Development
Dhaka
19-22 December 2011

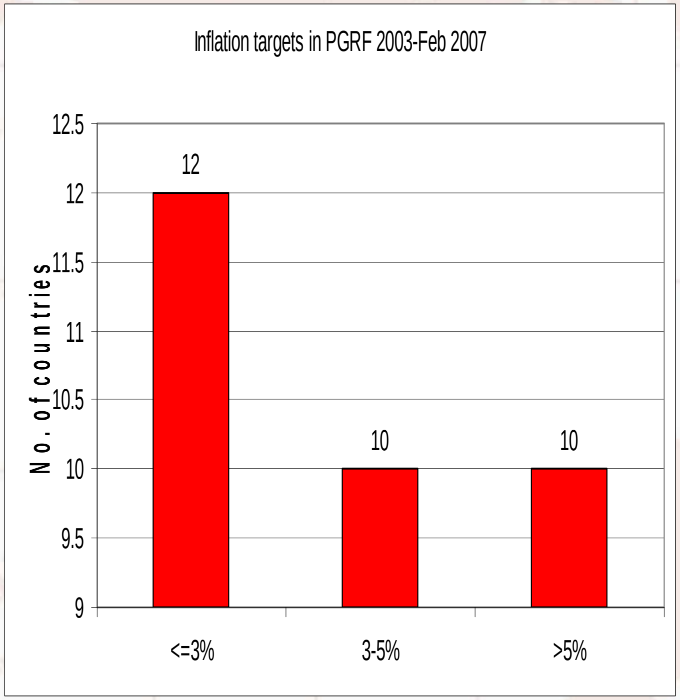
Outline

- Inflation-growth-poverty: inconclusive evidence
- Inflation targeting: costly trade-offs – limits of Taylor rule
- Sources of inflation: food price, imported – limits of monetary policy
- Beyond inflation targeting: multiple targets & pragmatism

Inflation matters, but targets can contract

"On balance, … support the use of single digit inflation targets….However, pushing inflation too low—say, below 5 percent—may entail a loss of output and seigniorage revenue, suggesting a need for caution in setting very low inflation targets in low-income countries. .. Inflation targets should be set so as to help avoid risks of an unintended contractionary policy stance." (IMF, 2006: 17)

Actual targets: 5% or less



Source: Goldsbrough, Adovor & Elberger (2007)

Of 32 program countries, inflation target 5% or less in 22 (69%)!

Inflation target <5% in 29 SSA IMF program countries in 2000s (IEO, 2007)

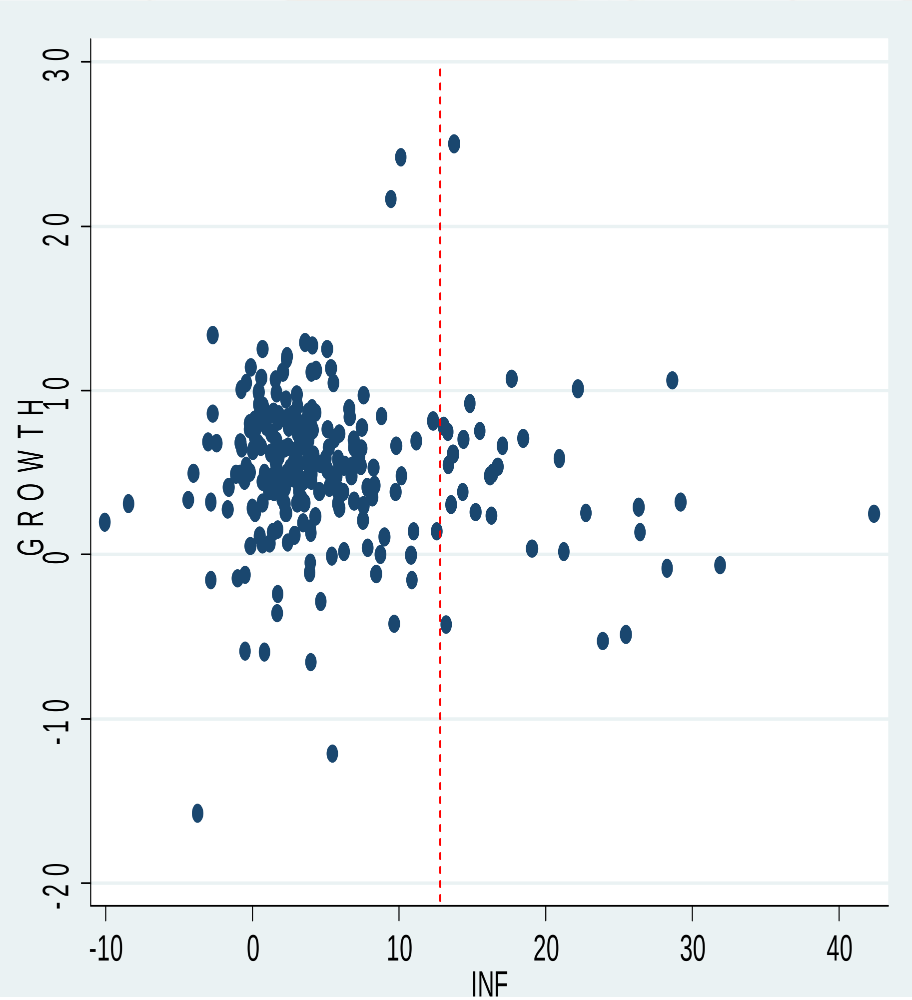
Clearly, actual policy <u>not</u> based on research findings

Does inflation harm growth?

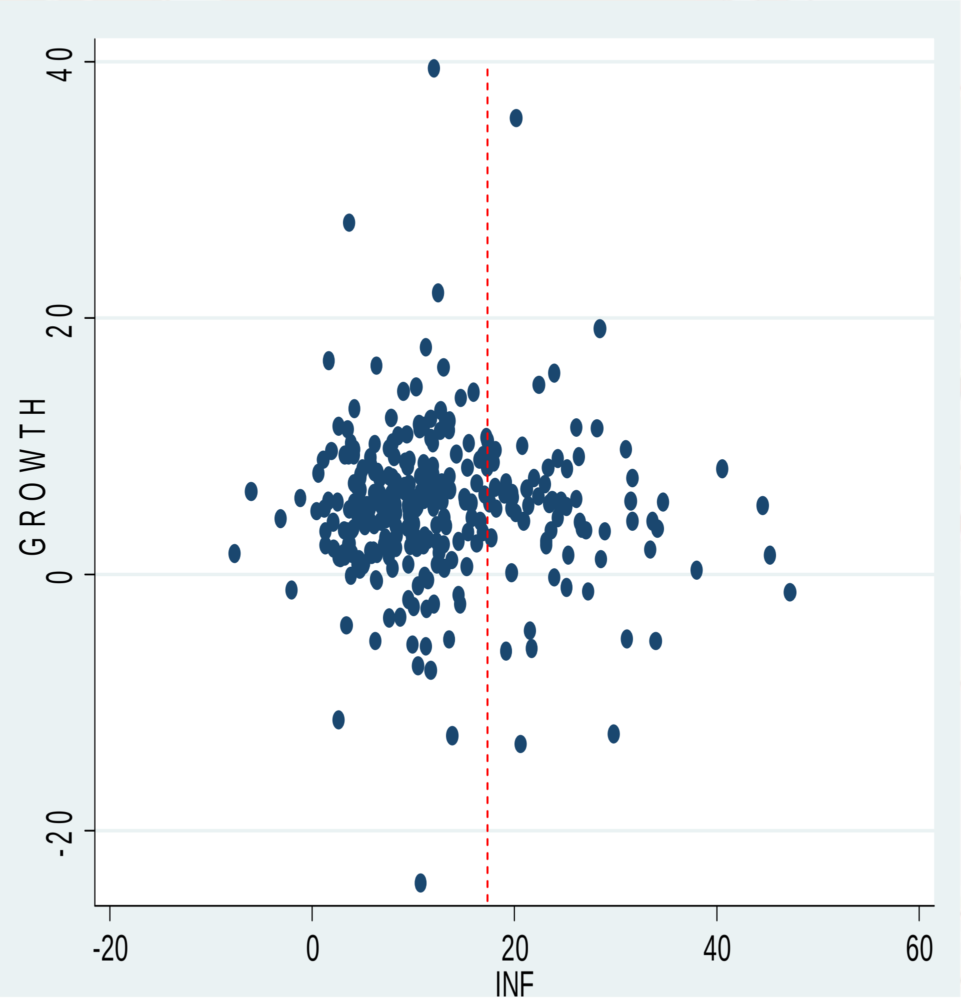
- "Historically, all possible combinations have occurred: inflation with and without [economic] development, no inflation with and without [economic] development." (Friedman, 1973: 41)
- "The ratio of fervent beliefs to tangible evidence seems unusually high on this topic." (Bruno & Easterly, 1998: 3)

Inflation not bad for growth (40 developing countries)

1960s

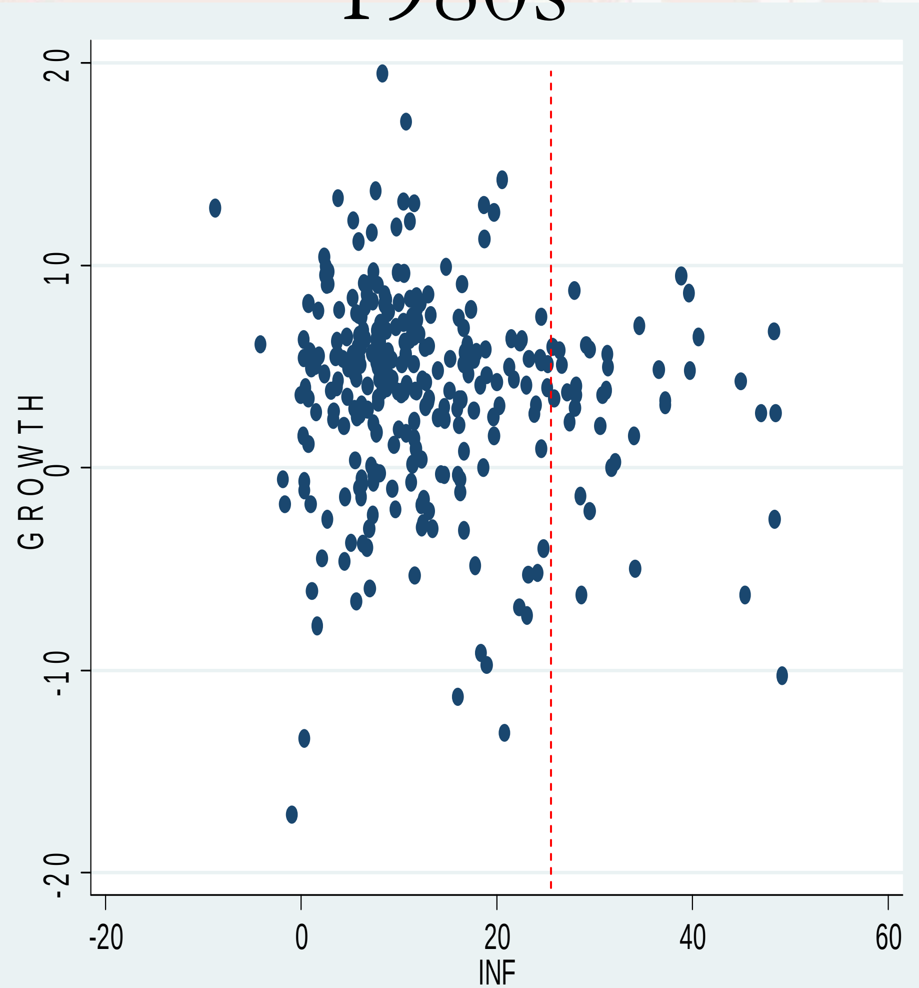


1970s

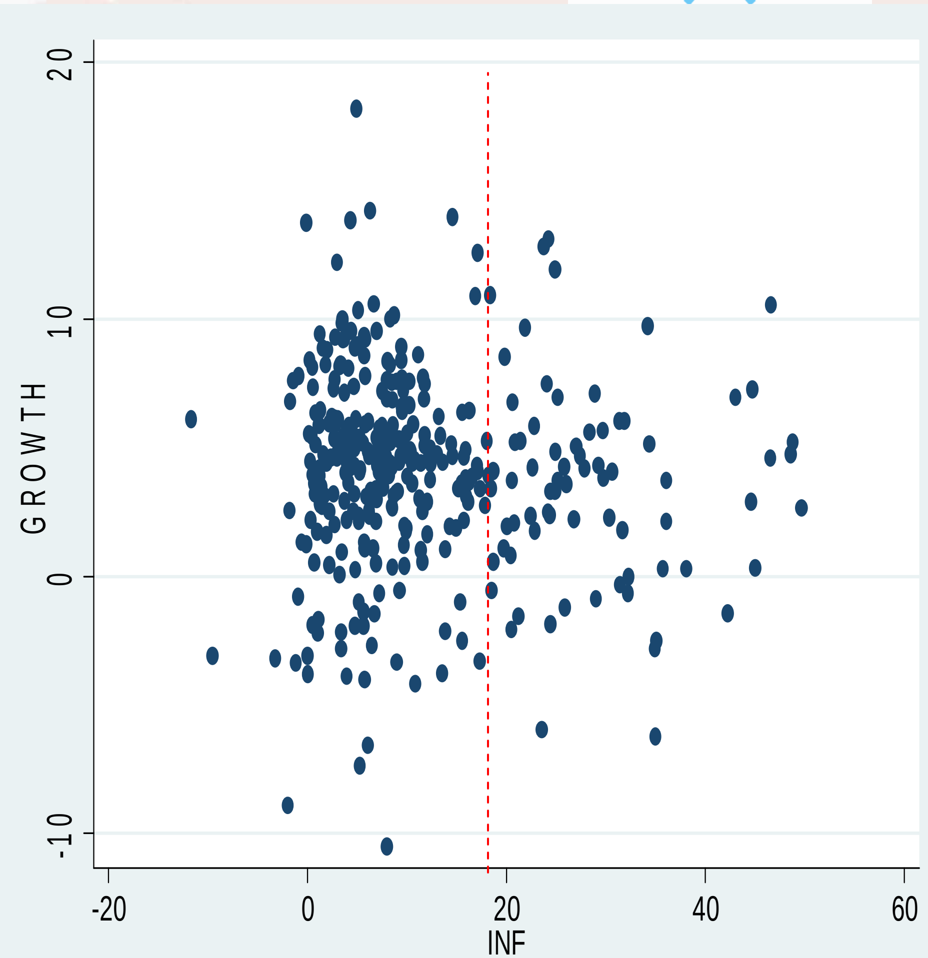


Evidence inconclusive

1980s



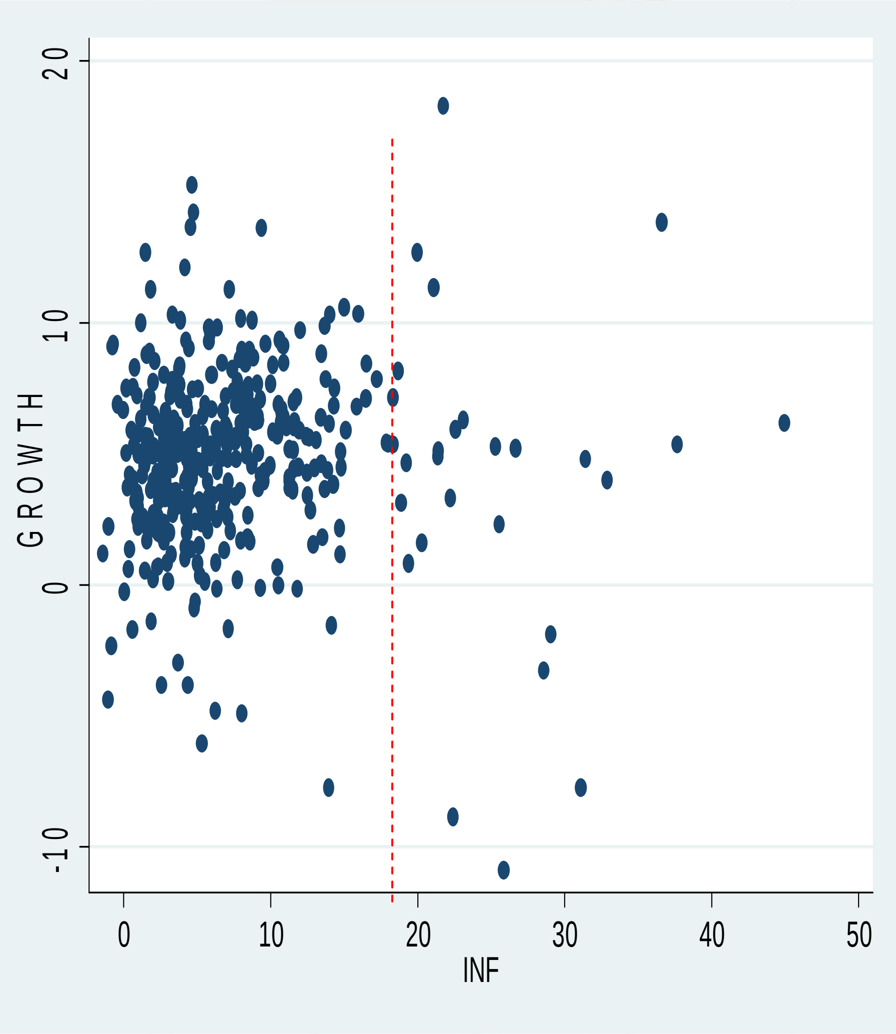
1990s



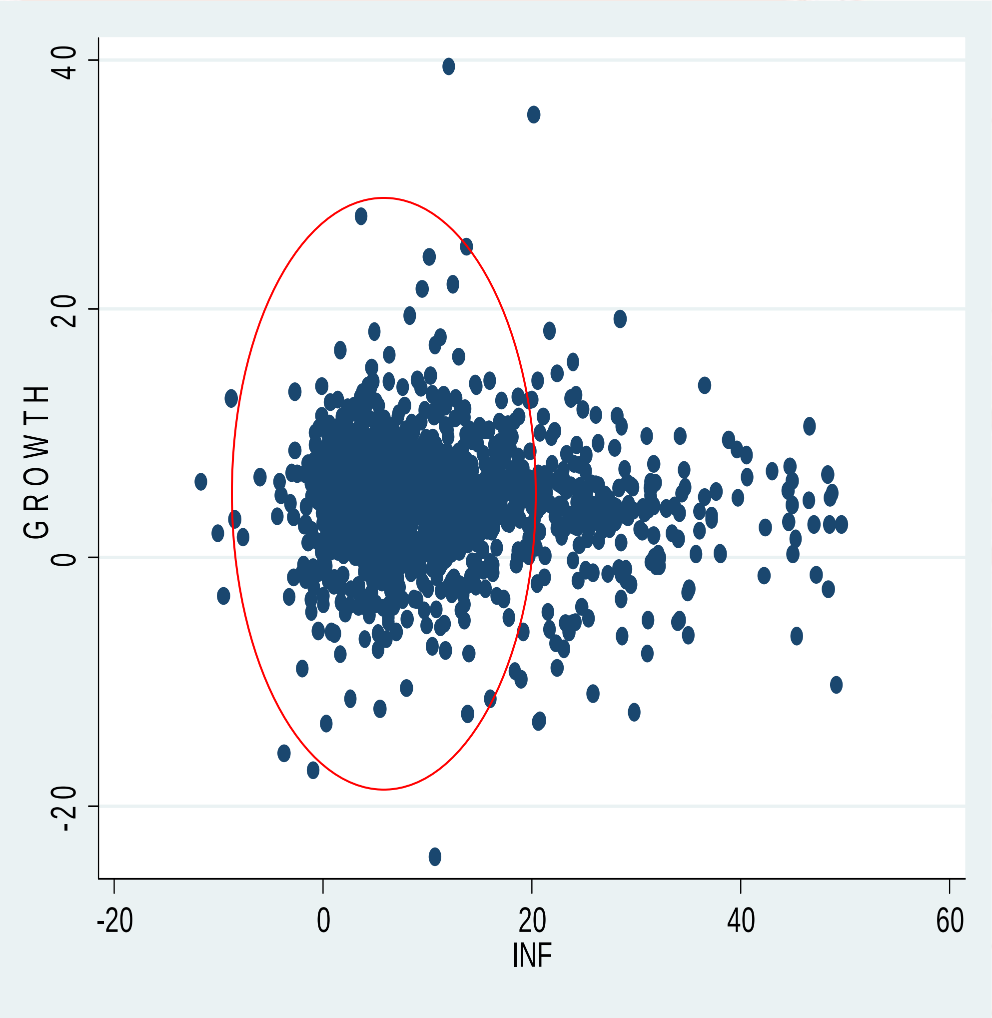
"IMF policy staff acknowledge that the empirical literature on the inflation-growth relationship is inconclusive" IEO (2007: 10)

Mild +ve relation up to 20%

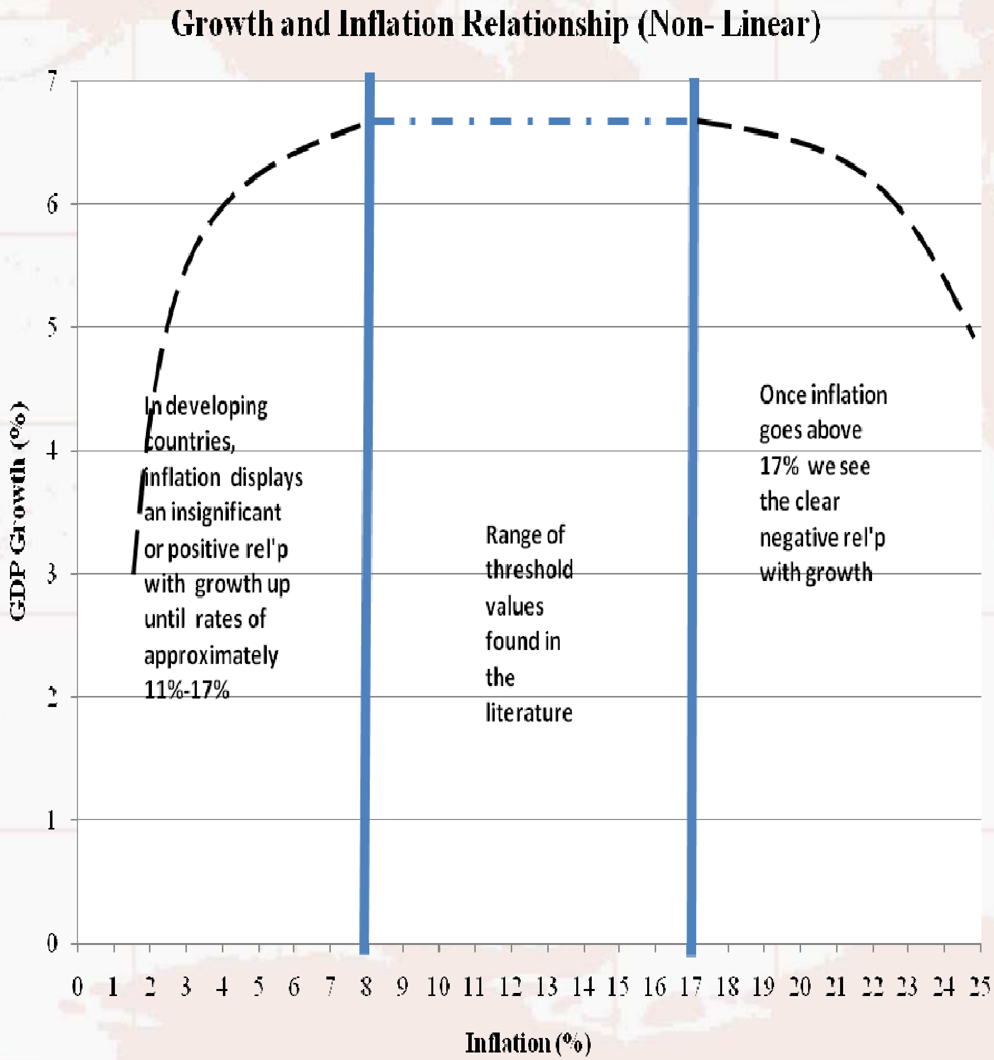
2000s



1960-2010



Low inflation can hurt

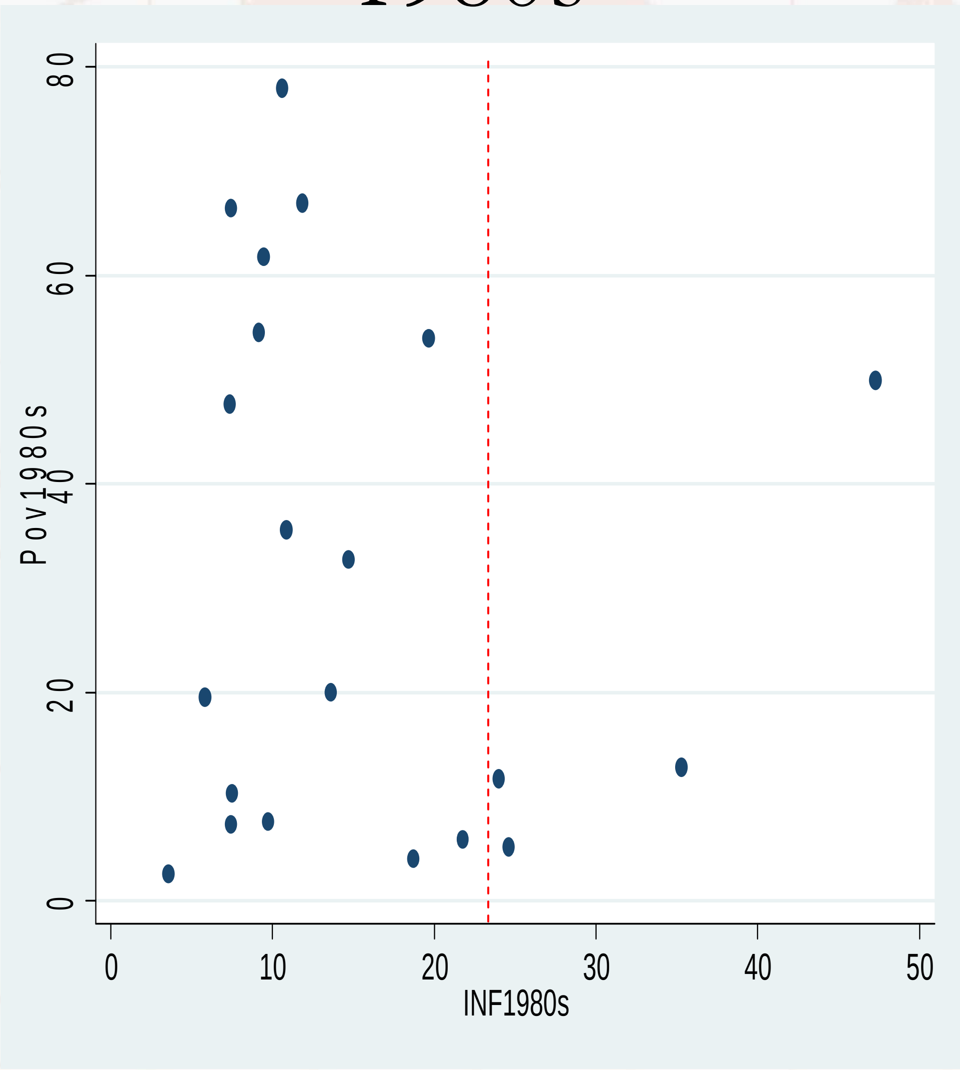


Source: Anwar & Islam (2011)

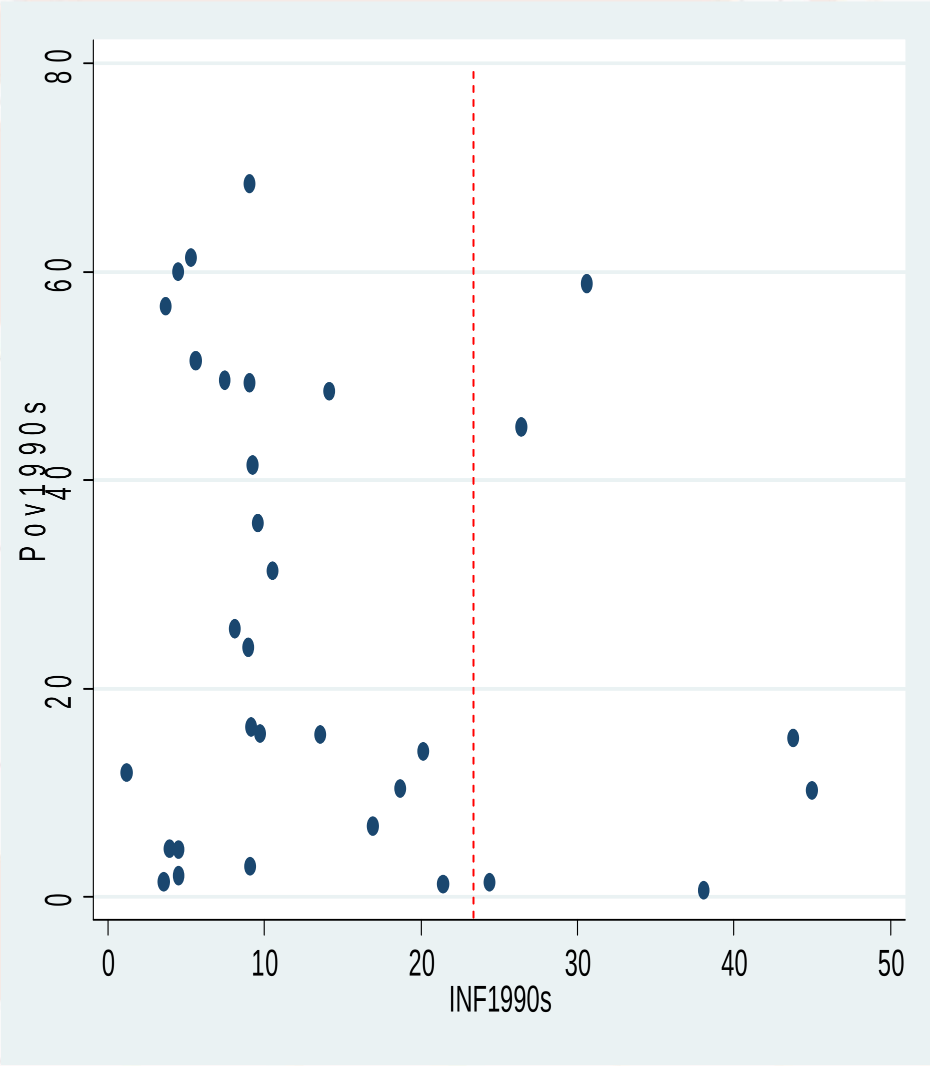
- Inflation >5% does not harm growth.
- Trying to keep inflation at low single digit level may harm growth

Inflation bad for poor?

1980s

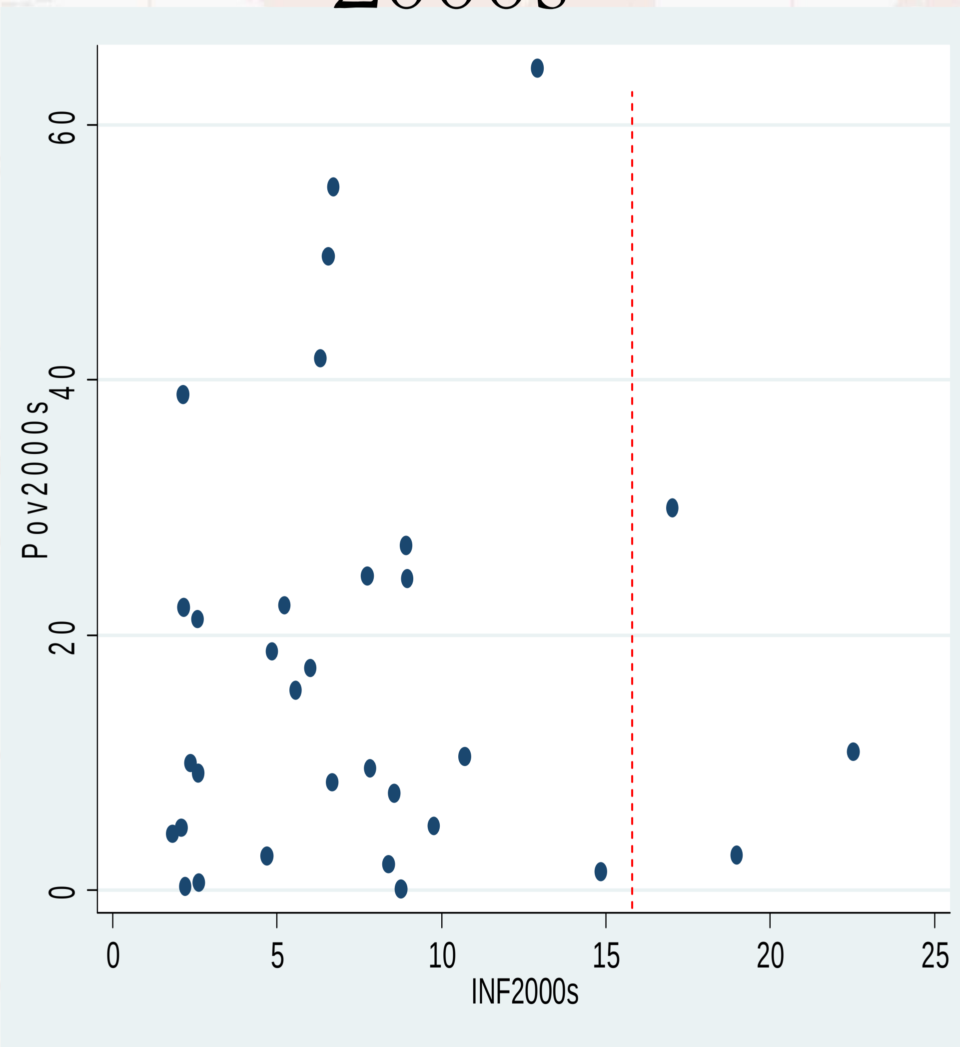


1990s

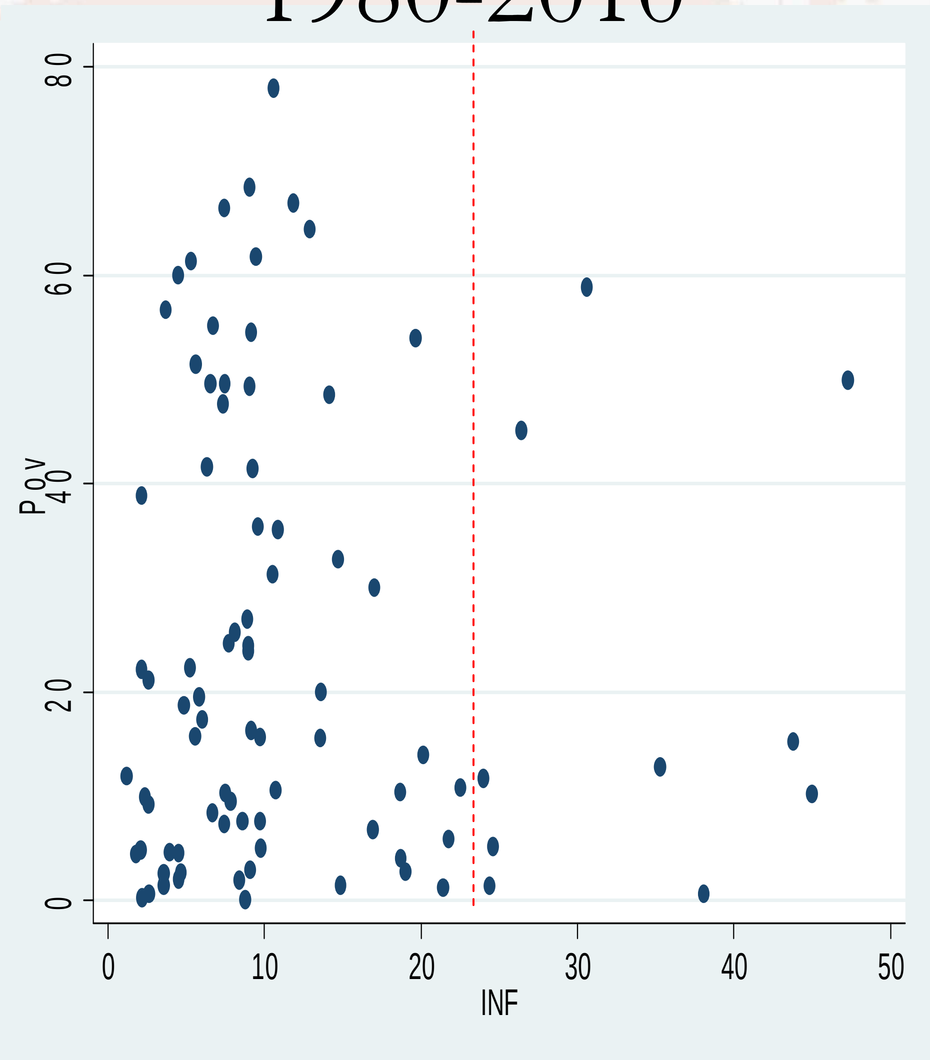


Mild -ve relation up to 20%!

2000s



1980-2010



Impact of inflation on poor depends on:

- Real wage & employment effects
- Wealth & net debt effects
- Food & other essential prices

What next? – Back to basics

- No suggestion that deliberately targeting higher inflation can yield faster growth or poverty reduction. It depends considerably on the inflation history and institutional arrangements of each country
- IMF Article IV: … each member shall:
  1 (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances

Inflation targeting – What are the trade offs?

Very low target reduces fiscal space

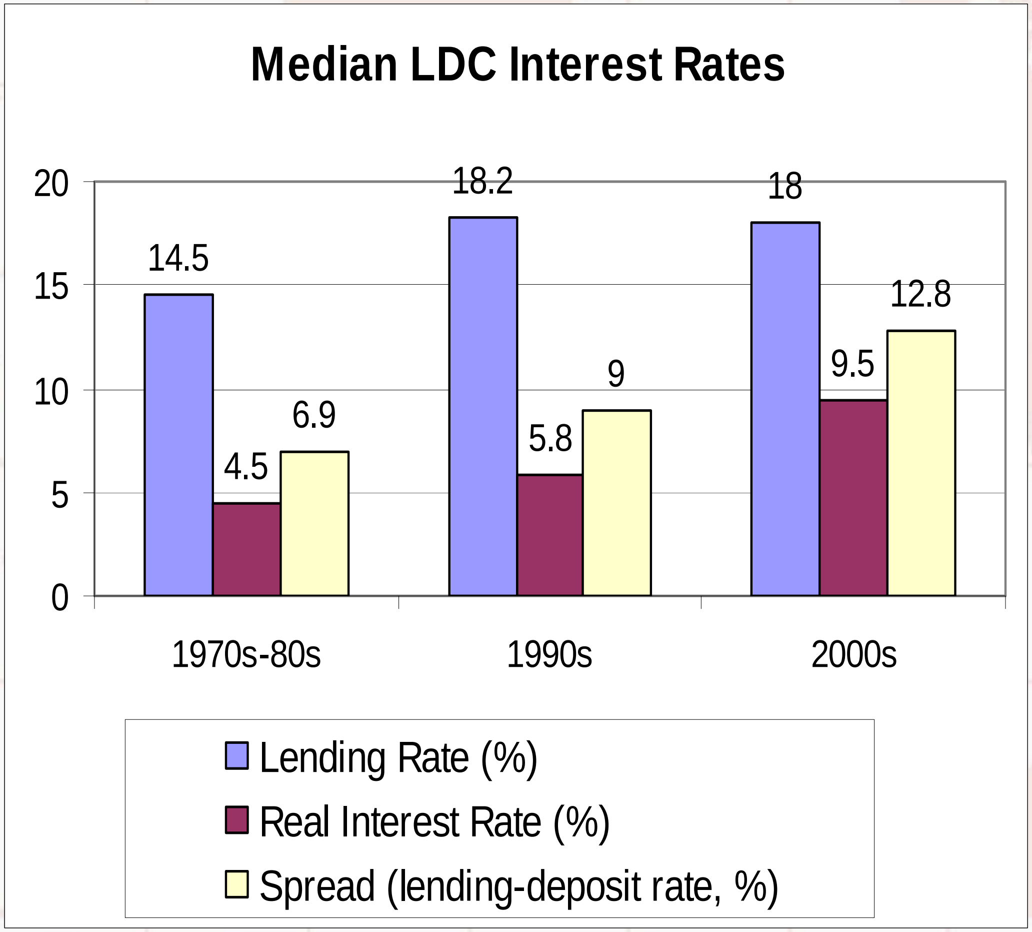
- Inflation > typical in IMF programs → additional fiscal space, via monetary financing of fiscal deficit
- Additional monetary expansion → higher inflation → redistribute resources toward the government (via the inflation "tax" on those holding currency)
- Inflation tax is distortionary; but other taxes are distortionary too
- Given the low tax base and collection, inflation tax (seigniorage) is impt source of revenue

Higher interest rates

- Higher government borrowing costs & deficit even if no new spending
- Lower private investment
- Attract short-term capital flows:
  – pushes up exchange rate
    → loss of competitiveness
  – increases financial sector fragility

Interest rate response asymmetric

Lending rates rise with policy rate, but do not fall



Source: Anwar & Islam (2011)

Lower inflation, but high borrowing costs in 2000s

Oligopolistic banks

Premium of reduced inflation captured by big banks; NOT passed on to borrowers

Exchange effects: Differential lags

- Shorter lag of pass through; imported inflation
- Longer lag of aggregate demand effects
- Frequent adjustments of exchange rate to achieve inflation target, can produce growth, employment instability

Taylor rule – simple, but difficult

- No precise basis for choice of coefficients
- Actual variables required for implementation – equilibrium real interest rate, potential output – not observable – must be inferred from other information. Nominal & real output not known with any accuracy until much later
- Output gap may narrow due to decline in potential output; not due to rise in actual output
- Given these uncertainties, central banks tend to be cautious in interpreting economic data, and to smoothen interest rate paths

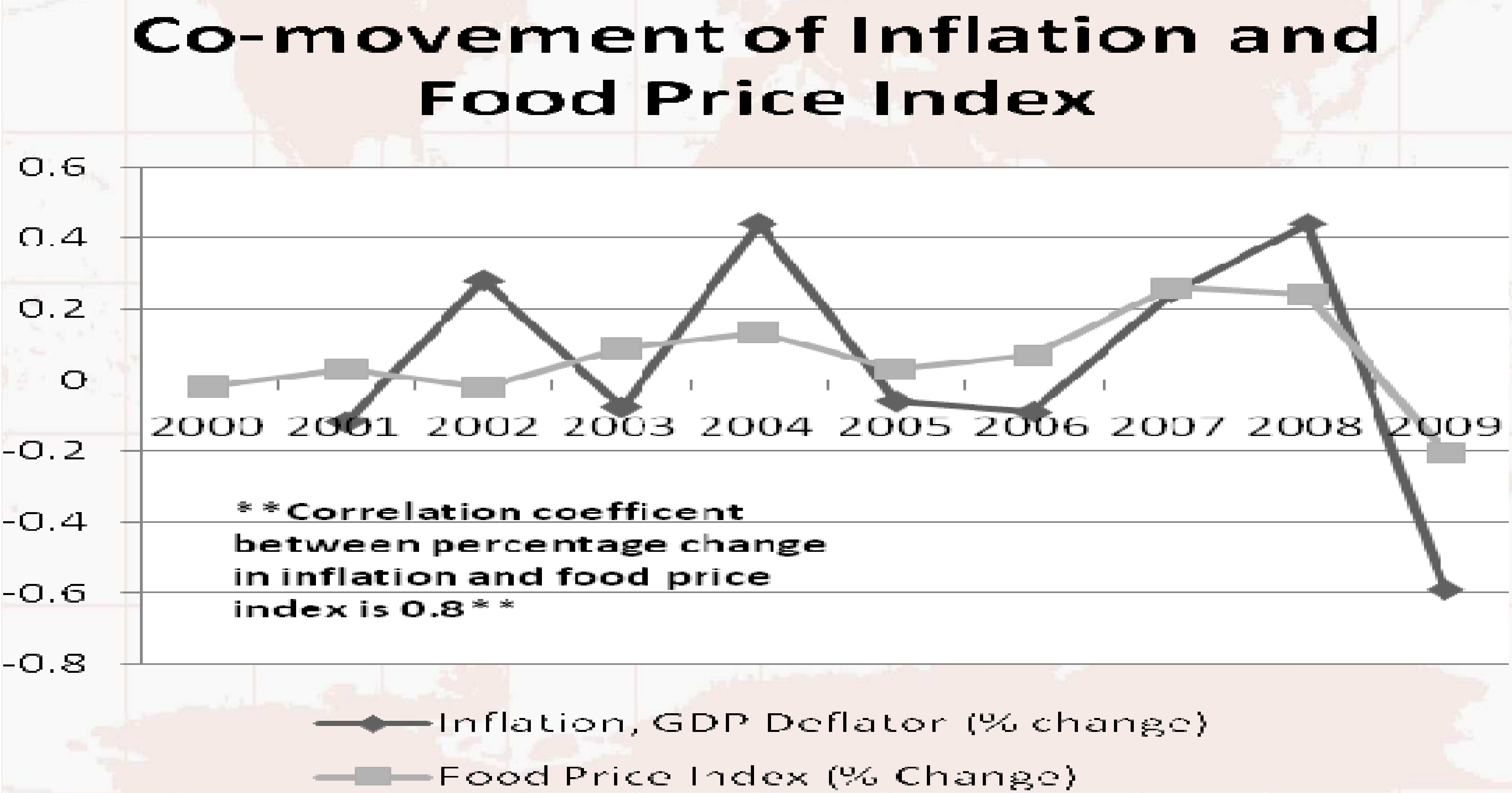
Taylor rule – rigid & costly

- Rigid commitment to one instrument rule
  - – violates Tinbergen rule – biased towards inflation (Blanchard: 'divine coincidence')
  - – no room for judgment or discretion
- Reliance on interest rate – limits policy options – can be costly
- May encourage unhelpful market speculation or prevent a central bank dealing promptly with a crisis (Greenspan & Bernanke)
- No explicit account of exchange rate and food price or imported inflation
- IMF (WP/05/148, 2005): possibility of abuse

Sources of inflation matter

Dealing with imported inflation

Supply shocks – imported food & energy



Source: Anwar & Islam (ILO, 2011)

Should monetary policy be tightened?

- "Let's kill GDP – Inflation will fall" Surjit Bhalla, ex-WB economist on recent RBI efforts
- Greater output fluctuations when focused on price stability
- Pro-cyclical bias of IT monetary policy in responding to supply shocks

Dealing with food price inflation

- Rationing & public distribution
- Provision of social wage
- Non-inflationary wage adjustments
- Needs expanded fiscal space

Beyond inflation targeting

Monetary policy after the crisis

IMF research rethinking

"Before the crisis, mainstream economists and policy-makers had converged on a beautiful construction for monetary policy. … we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate. And that was basically enough to get things done.

If there is one lesson to be drawn from this crisis, it is that this construction wasn't right, that beauty is unfortunately not always synonymous with truth. The fact is that there are many targets and there are many instruments." (Blanchard 2011)

Monetary policy

- Avoid stabilisation trap: Recognise both price, growth stabilisation roles
- Participatory policy making -- trade-off inflation, unemployment parameters
- Monitor asset price inflation – curb unproductive lending
- Greater use of other instruments, e.g. reserve requirement, directed credit
- Encourage productive investment, SMEs, agriculture
- Coordinate with fiscal authority to stabilise food prices

References cited

- Anwar, S. & Islam, I. (2011). Should Developing Countries Target Low, Single Digit Inflation to Promote Growth and Employment?, ILO WP #87
- Blanchard, O. (2011). 'Monetary Policy in the Wake of the Crisis', IMF Macro Conference, March
- Bruno, M, & W Easterly (1998). Inflation Crises and Long-run Growth. *J. of Monetary Economics*, 41: 3-26
- Friedman, M. (1973). *Money and Economic Development*, Toronto: Lexington Books
- Goldsbrough, D. Adovor, E. & Elberger, B. (2007). Inflation Targets in IMF-Supported Programs. Center for Global Development, Washington, DC.
- IMF (2006). Designing Monetary and Fiscal Policy in Low-Income Countries. Occasional Paper 250.

Thank you

Visit DESA website for:

- Macroeconomic Advisory Capacity (MAC) Policy Notes
- National Development Strategies (NDS) Policy Notes
- Working Papers

http://www.un.org/en/development/desa/