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

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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

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 not based on research findings

Source: Goldsbrough, Adovor & Elberger (2007)
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
“IMF policy staff acknowledge that the empirical literature on the inflation-growth relationship is inconclusive” IEO (2007: 10)
Mild +ve relation up to 20%
Low inflation can hurt

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

Source: Anwar & Islam (2011)
Inflation bad for poor?

1980s

1990s
Mild -ve relation up to 20%!
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**

Lower inflation, but high borrowing costs in 2000s

Oligopolistic banks

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

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Median LDC Interest Rates

<table>
<thead>
<tr>
<th>Period</th>
<th>Lending Rate (%)</th>
<th>Real Interest Rate (%)</th>
<th>Spread (lending-deposit rate, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970s-80s</td>
<td>14.5</td>
<td>4.5</td>
<td>9.5</td>
</tr>
<tr>
<td>1990s</td>
<td>18.2</td>
<td>5.8</td>
<td>12.4</td>
</tr>
<tr>
<td>2000s</td>
<td>18.5</td>
<td>9.5</td>
<td>9.0</td>
</tr>
</tbody>
</table>

Source: Anwar & Islam (2011)
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

Co-movement of Inflation and Food Price Index

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
“Before the crisis, mainstream economists and policymakers 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

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