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Should central banks raise inflation targets?


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- *Advocates put forward mainly three arguments for raising central banks' inflation targets: first, distance from the zero lower bound on interest rates, given a secular decline in the natural rate of interest; second, ongoing and forthcoming secular economic developments which may put upward pressure on inflation in the years to come, and third, debt relief through lower real interest rates and an inflation of nominal debt.*
- *Major central banks have carefully evaluated the optimal inflation target in their 2019-2021 strategy reviews. These reviews led to the decision to only marginally adjust inflation targets upwards to around 2%, or to leave the target at this level. On balance, economic research did not support higher inflation targets. Over the past two years since the strategy reviews, the balance of arguments would seem to have further tilted against higher inflation targets.*
- *Central banks' tolerance of future inflation overshooting after low inflation for long, embedded in their revised strategies or forward guidance, may have contributed to the recent surge in inflation. Raising inflation targets as such risks fueling inflation even more.*
- *Recent experience has shown how fast headline, but also underlying, inflation can rise to very high levels. The risks of too high versus too low inflation should therefore be weighted anew, with more emphasis on preventing too high inflation.*
- *Using novel unconventional monetary policy instruments, central banks have proven that they can cope with downturns close to or at the effective lower bound on interest rates. Furthermore, recent estimates suggest that the natural rate of interest rates may have passed its low and has been rising recently, alleviating constraints from the effective lower bound.*
- *A purely macroeconomic assessment of optimal inflation is incomplete. Inflation – even at moderately higher levels than current central banks' targets – triggers distributional conflicts, opens the door for arbitrary and populist state intervention in the price mechanism and the social transfer system, and may undermine trust in state institutions at large. Citizens regard stable state monopoly money as an important public good, which the central bank is expected to guarantee.*
- *Relative price stability in the sense of inflation around 2% in the medium to long run has been hard earned and should not be relinquished for light reasons.*

1. The return of new old acolytes of higher inflation targets

Some observers have now and again brought up the idea of central banks' inflation targets being raised from 2% (which has been established as a quasi-standard among most central banks over past decades) to 3% (Blanchard, 2022, Haldane, 2023) or 4% (Blanchard et al, 2010, Ball, 2013). Arguments include:

1) A higher inflation target increases the **distance from the zero lower bound on interest rates**. This has become more important given the secular decline in the natural rate of interest, around which the central bank's policy rates oscillate depending on the position in the business and inflation cycle. Thus, a higher inflation target would create more leeway for central banks to fight recessions or crises through nominal interest rate cuts, instead of, or in addition to, QE. Instances where the zero lower bound on nominal interest rates would become binding would become less probable.
2) Various global developments, such as climate change, climate protection, geopolitical tensions and de-globalization, and increasing labor shortages (demographics, changing preferences) might structurally create **upward pressures on inflation for many years**. These are beyond central banks' control of demand side policy. Keeping inflation at 2% would require a permanently restrictive monetary stance, to fight these persistent supply-cost-driven inflation upward pressures (see Cavaliere, 2023, El-Erian, 2023).
3) Higher inflation would help to gradually **solve the global problem of high public and private debt** through the "inflation tax" (Goodhart et al, 2021).
4) According to proponents of an inflation target rise, the increase would make little difference in terms of welfare losses, since, given all the uncertainty and divergence in the economic literature, the notion of an optimal inflation target can in any case not be pinned down at a narrow 2%. **Costs of slightly higher inflation would be outweighed by benefits**.

How valid are these arguments? What had major central banks' strategy reviews conducted between 2019 and 2021 to say on this topic? In how far has the world changed since then, and what might be possible implications for the verdict on the optimal inflation rate?

2. What insights from recent central banks' monetary policy strategy reviews?

The **ECB's Strategy Review of 2020-2021** (ECB, 2021a) included a comprehensive and balanced state-of-the art review of the existing literature on the optimal inflation rate (see ECB Work Stream 2021, pp. 17-53, Consolo at al, 2021). Overall, it found that, compared to economic research existing at the time of the previous strategy review of 2003, the arguments for a slightly positive inflation target had become stronger. This was mainly due to the more frequent incidence of low inflation-low nominal interest rates periods in the aftermath of the GFC. However, inflation rates above 2% were found to entail considerable risks with respect to credibility, a de-anchoring of inflation expectations and redistributive effects (see ECB Work Stream, pp. 17-53). Accordingly, the ECB's monetary policy strategy review resulted in a slight upward adjustment of the ECB's inflation target from "below, but close to 2%" to "2% over the medium term," with an emphasis on the target being symmetric.

Concepts such as average inflation targeting did not find support, due to their uncertain consequences and potentially destabilizing properties. Some notion of a temporary overshooting of the inflation target, in order to re-anchor inflation expectations, was, however, incorporated in the monetary policy forward guidance immediately following the announcement of the strategy review (ECB, 2021b).

The **Federal Reserve System's** 2019-2020 Review of Monetary Policy Strategy, Tools, and Communications (Federal Reserve, 2020) affirmed "that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate." Importantly, the Fed adopted average inflation targeting as its new strategy, as reflected in the FOMC's statement that "in order to anchor longer-term inflation expectations at this level [of 2 percent], the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time".

Similarly to the Fed, the **Bank of Canada** in its 2021 Monetary Policy Framework Renewal (Bank of Canada, 2021) confirmed that it would continue to target 2% inflation within a 1 to 3 percent control range. To arrive at this result, it conducted a "horse race" of key alternatives to inflation targeting, namely average inflation targeting, a dual mandate of targeting both inflation and employment, nominal gross domestic product (level or growth) targeting, and price-level targeting. It concluded that the inflation-targeting framework is flexible enough to mimic some attractive elements of average inflation targeting and a dual mandate, without the drawbacks associated with these alternative approaches. Thus, the flexible inflation targeting was retained as the strategy.

While phrased differently, all three strategy reviews had in common that the central banks committed to allowing inflation to overshoot for some time after an extended period of undershooting the target. In practice, this amounted to a temporary increase in the inflation target over the short-term, with the aim of bringing inflation expectations back to target after a period of below-target inflation outturns and inflation expectations. The strategy reviews did not, however, raise long-term inflation targets.

3. How might these findings be adapted in light of the recent inflation experience and new economic research?

The strategy reviews have in common that they were conducted at a time when euro area inflation had been persistently undershooting targets for several years, prompting massive non-conventional monetary policy, notably QE, forward guidance and, in the case of the ECB, negative interest rate policy. Recent studies broadly confirm that these unconventional monetary policies were largely effective in compensating for reduced leeway from the zero lower bound on nominal interest rates, albeit with a number of confirmed as well as contested non-marginal side effects (including liquidity overhang, "zombie" firms, asset booms, distributive effects, central banks' dominance in money and bond markets, etc.).

An update of the analysis on the optimal inflation rate conducted in the strategy reviews, in the light of the recent period of very high inflation will have to incorporate new economic research just emerging. It seems likely that these findings will strengthen arguments emphasizing the risks and costs of high inflation. While in the years preceding the pandemic, the consensus was that too low inflation was the main enemy and that higher inflation could in any case always be brought back to target relatively easily (since there is theoretically no upper bound on nominal and real interest rates), this view needs to be recalibrated: First, it seems that inflation can even more quickly and strongly soar to very high levels than it falls to zero or below. And it turns out that fighting inflation in practice faces numerous constraints from financial stability, fiscal sustainability as well as political economy and decision-by-committee inertia. Too high inflation is at least as big a problem as too low inflation, and a more symmetric approach than the one adopted in central banks' latest strategy reviews is called for (and, with hindsight, would have been warranted during the strategy reviews).

Indeed, some (Reis, 2022a) have argued that central banks' slight upward adjustment of price stability targets, in the form of the above mentioned adoption of "average inflation targeting" (Fed), "patience" in withdrawing monetary stimulus (BoC) and the ECB's post-strategy review forward guidance that reaching the medium-term inflation target of 2% "may also imply a transitory period in which inflation is moderately above target" (ECB, 2021) may have fueled the rise in inflation through delayed withdrawal of monetary policy accommodation and dovish signaling of central banks' tolerance of inflation. If this reading of recent development were correct, it would reinforce the call for caution against even moderate tinkering with the inflation target.

Furthermore, recent estimates (e.g. Villeroy de Galhau, 2023, Luzetti et al, 2023) suggest that the natural rate of interest rates r* has passed its low and has been rising recently, alleviating constraints from the effective lower bound. Others (Reis, 2022b) raise the issue which equilibrium interest rate (of government bond markets or of private investment) the central bank should consider. These findings may imply that key foundations arguing for higher inflation targets to counter the zero lower bound on interest rates may be flawed.

4. Why tinkering with current inflation targets is not advisable

Against this background, there are many arguments against "tinkering" with central banks' 2% inflation targets even moderately. These arguments can be subsumed into six groups:

4.1 Salience, non-linearities in agents' behavior, and economic inefficiencies

- Former Fed President Alan Greenspan once defined price stability as "that state in which expected changes in the general price level do **not effectively alter business and household decisions**." (Federal Reserve System, 1996, p. 51): While it is not implausible that this may be the case for central banks' current 2% inflation targets, the same becomes harder to argue for 3% or 4%.
- This is all the more the case since the **behavior of economic agents is likely non-linear with respect to inflation**: While trade unions, firms and the public sector may largely ignore inflation when it is low, economic agents' and policy makers' behavior may change suddenly once they start focusing on inflation. This implies that second round effects and self-sustaining or even reinforcing mechanisms may come into play. If this were the case, it would be harder for the central bank to keep inflation firmly anchored and might require bolder policy actions to keep inflation stable at the target.
- Higher inflation entails higher price adjustment costs ("**menu costs**"), **information costs** and the costs from avoiding cash or unremunerated accounts ("**shoe leather costs**").
- Higher inflation targets plausibly go hand in hand with **higher inflation variability**. The uncertainty created raises the **inflation risk premium** and thus financing costs. This puts a drag on investment and potential growth. Higher inflation introduces "noise" into the pricing mechanism. It makes the **economy more complex to understand** – which entails higher costs for all economic agents and policy makers and thus contribute to lower productivity growth. A higher inflation target may thus contribute to a lower r*, the very effect it wants to compensate.

4.2 Distributive effects, social hardship, loss of trust in state institutions, and populism

- The additional complexity and uncertainty introduced in households' everyday decisions entails financial consequences from education. Thus, higher inflation affects those with **better economic and financial education less**, while **expropriating small savers** who do not have the knowledge, risk-bearing capacity and required minimum lot size to save and invest in equity and real estate.

- The notion that moderately higher inflation entails comparatively small costs, since indexation can solve any allocative effects, is flawed. **No indexation is perfect**. Therefore, higher inflation entails, unavoidably in practice, sizable **redistributive effects**, with multiple **allocative distortions** beyond the control of policy makers.
- At a societal level, inflation likely triggers and reinforces **redistributive conflicts** – between wage earners and entrepreneurs, the private versus the state sector (e.g. through bracket creep, the non or incomplete indexation of social transfers, pensions etc.), and various groups of wage earners (favoring those with lobbying and public pressure capabilities etc.). Higher inflation paves the way for **populism** and the extreme fringes of the political spectrum.
- Price stability is not only a means to an end (i.e. to support investment, growth, and employment in the long-run, to avoid socially unfair redistributive effects). It is also valid as a policy goal in itself, as high **inflation and the cumulative debasement of the currency over time weakens public trust in state institutions**. E.g. over half of respondents (53 percent) to a survey conducted by the Bank of Canada in the context of its 2021 monetary policy strategy framework renewal replied that "they would prefer to have stable and predictable inflation so that they can better plan their lives. Only 27 percent said steady economic growth was more important, while 20 percent said maximum sustainable employment was more important". (Bank of Canada, 2021). In a similar vein, Makhlouf, 2023, sees the preservation of price stability as key to preserving trust in state institutions and social capital.

4.3 Anti-inflationary state intervention, central bank as quasi-fiscal authority through "inflation tax"

- Higher inflation opens the door for, indeed **invites, state intervention in market price formation**. Energy price caps, rent control or caps all quite obviously carry the risk of **allocative distortions** and side effects. These interventions may amount to **sizeable infringements upon legal property rights** (e.g. non-indexation of property rents) **and income flow entitlements** (e.g. over- or under-indexation of retirement pensions and other social transfers).
- The **"inflation tax" circumvents democratic decision-making procedures**. It may entail taxation which would in other more explicit form, not pass parliamentary law making. **Central banks are no fiscal authorities**, their mandate does not include taxation or redistribution, on purpose or as an avoidable side effect.
- Ultimately, this overextension of central banks' remit may endanger their credibility, public acceptance and independence.

4.4 Staying within the legal boundaries of "price stability" mandates

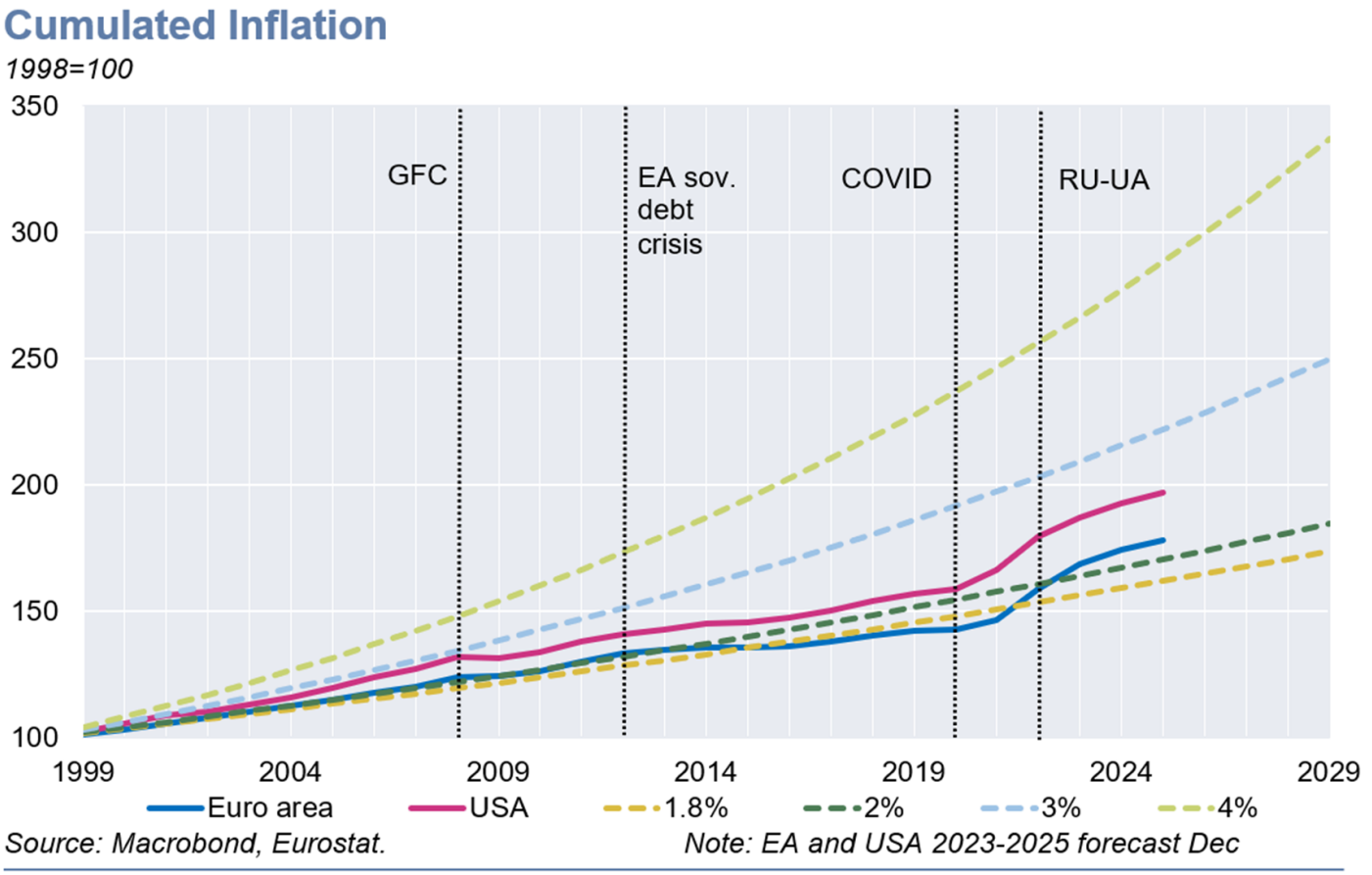
- While an inflation target of 2% can reasonably be argued to be in line with the EU Treaty's primary mandate for the Eurosystem to "maintain price stability", this could clearly be less so for a, say, 3% or 4% target. Similar arguments were put forward for the USA. E.g., former New York Fed president William Dudley doubted "that a higher inflation target would be viewed as consistent with the Federal Reserve's Congressional mandate to pursue price stability" (Dudley, 2018).

4.5 Even small inflation target increases amount to huge losses of money value over time

- The seemingly small difference between 2% and, say, 3% or 4% makes a substantial difference in the long run, due to a) cumulative and b) compound interest effects. A simple illustration: 2% inflation over 10 years accumulates to 21.9% loss of purchasing power, 3% of inflation over 10 years accumulates to 34.4% (so, over one third), and 4% of inflation over 10 years accumulates to 48% (so, almost one half). Obviously, over 20 or 30 years the gap becomes more pronounced (see table).

Table: Cumulative price increase for 2%, 3% and 4% inflation target over 10, 20 and 30 years
(Index in %, starting year = 100)

Inflation target	2%	3%	4%
10 years	121.9	134.4	148.0
20 years	148.6	180.6	219.1
30 years	181.1	242.7	324.3



4.6 Opportunistic talk of higher inflation targets can damage trust and acceptance of public money and central banks

- Central banks are currently working hard to preserve credibility and keep inflation expectations anchored at the 2% target. A de-anchoring of inflation expectations would amount to an upward shift of the Phillips curve, which implies worse inflation outcomes without reaping even temporary benefits. **Advocating a rise in central banks' inflation target could trigger a loss of trust and de-anchor inflation expectations**, requiring central banks to counter an entrenchment of inflation through tighter monetary policy, lower output and employment.
- In the decade and a half following the Global Financial Crisis up to the early phase of the pandemic, calls for (temporarily) higher inflation targets could be argued as an attempt to bring inflation expectations up to target and thus to avoid a deflation trap. At the current juncture of far-above-target inflation, such calls can obviously no longer usefully serve such purpose. By contrast, they may be perceived as **opportunistic** in the sense that central banks might through an **opportunistic increase in inflation targets** escape the need to deliver on their announced inflation target by means of a recession (see Cavaliere, 2023, El-Erian, 2023). This might seriously damage central banks' public acceptance, credibility and ultimately independence.

- Calling for a rise in central banks' inflation targets due to structural secular supply-side shocks which may entail upward pressure on prices seems inadequate for two reasons: first, the mirror argument should then have been brought forward in the past, when central banks undershot inflation targets, which was inter alia also due to globalization, cheap energy, ample labor supply etc. Instead, central banks undertook huge efforts, with unconventional policies, to bring inflation back up to their 2% inflation targets. Arguing differently in a period of inflationary supply shocks would introduce an upward bias to inflation and seem opportunistic. Second, and related to the first argument, the evolution of the **general price level in the end is a question of monetary accommodation of whatever shocks**. Rises in energy prices, raw materials and labor are in the first place changes in relative prices; how they feed through into the general price level (and thus ultimately into consumer price inflation) is up to central banks' inflation targets. If central banks were to switch to a higher inflation target, inflation expectations would adjust upwards, and the level of real interest rates required to then keep inflation at this adjusted higher level should be all the same – if only credibility would not suffer. In reality, however, **central banks' opportunistic raising of inflation targets would damage their credibility, requiring higher – instead of lower – real interest rates to maintain inflation at any new higher level** for an in all likelihood extended duration of time.

Summing up, the economic gains from an - even supposedly moderate - increase in the inflation target, are – at best – temporary, if they exist at all. The costs are not only quite likely but large and permanent. ■

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