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How inflation targeting evolved

The benefits and drawbacks of pre-emptive versus reactive policies have not been adequately analysed

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The economic meltdown since 2008 has drastically altered the view of macroeconomists about the desirability of inflation targeting and the benefits of price stability. The acronym DIT stands for direct inflation targeting and I shall continue to use it. Given how pervasive opposition to it has become, one should not be surprised if the acronym is now used to mean the death of inflation targeting!


Illustration: Jayachandran / Mint

The backlash against monetary policy based on DIT is certainly justified. The policy failed miserably in the UK, which gave the Bank of England full independence, and then mandated it to pursue DIT. While the US collapse can be attributed to ultra-low interest rates during 2003-04 without a precise inflation target, the same cannot be said of the UK, which followed DIT quite strictly. However, other countries that followed DIT have not fared so badly—Canada and Australia, in particular—the reasons for which need to be separately examined. The backlash against DIT may have been overdone.

To understand how DIT evolved, it helps to start with Milton Friedman's December 1967 speech *The Role of Monetary Policy*. The rationale for DIT stems from his natural rate hypothesis: The central bank cannot control real variables in the long run, in particular the real interest rate, growth rate or unemployment rate. Of the three major nominal variables that he said it could control—the price level, the (nominal) exchange rate and money supply, he stated "the price level is clearly the most important in its own right".

Nevertheless, he concluded that the central bank should not directly target the price level (its current equivalent being DIT) because such a policy is reactive. An expansion in nominal demand first raises output, pushing the economy above its potential and only then filtering fully into inflation. So, a central bank should not wait to tighten policy until it sees inflation in "the whites of the eyes" of the data. Inflation feeds into new contracts, and controlling it later on will be much harder. On the other hand, tightening before inflation occurs may entail killing an expansion based on, say, productivity growth.

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Even without inflation, Friedman reasoned that policy should also be pre-emptive to stabilize output fluctuations. The real economy has substantial momentum of its own: Rapid growth feeds upon itself and so does rapid decline. This momentum can arise from both contagious Keynesian animal

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spirits and an accelerator process based on firms' profits and finances, greatly amplified by financial deregulation and lax lending. (Technically, at any given level of interest rates, real output follows a cyclical process with huge lagged values.) By the time the data indicate rising inflation and policymakers tighten, the economy could have turned down by itself. Thereby, the output downturn gets amplified by the reactive interest rate hikes. Friedman analysed the stability consequences of recognition, implementation and effectiveness lags in policy in 1951.

The scenario above partly captures the ongoing severe recession. The Fed started lowering the funds rate from its 5.25% peak in September 2007; the recession is dated as starting a bit later, in December 2007. In India and China, as inflation was rising rapidly in 2008, central banks tightened aggressively. Their cash reserve ratios were raised to a peak by September 2008, just before Lehman Brothers collapsed! At that time, the International Monetary Fund (IMF) and many others (me too!) expected inflation to rise for some more time, not a sudden collapse and deflation.

To avoid the potentially destabilizing dangers of reactive policies under uncertainty, Friedman instead proposed a money growth rule to be pursued automatically. A money growth rule is categorized as an intermediate target, pursued to indirectly achieve the final inflation target. Compared with DIT, it is a pre-emptive strategy. Independent of this money growth recommendation, Friedman separately also argued in 1962 that policy should be rule-based, not left to the discretion of the central banker. (A central bank that targets money growth can nevertheless do so using its discretion, not necessarily by a Friedman-type rule.) Otherwise, like politicians, central bankers will do what it takes to get re-elected or remain popular while in office. They will deliver short-term gain while causing long-term pain to the economy. A constitutional mandate for money growth thus would be pre-emptive and also avoid (in)discretion. In my opinion, Friedman's message about the benefits of rules versus discretion would have come across stronger and clearer if he had used the phrase rules versus indiscretion, instead of discretion!

It is analytically useful to characterize his and other monetary policy strategies, using a matrix. If we categorize policies along two sets of attributes—rules or discretion, pre-emptive or reactive, then Friedman belongs in the top left quadrant (see table). It should be pointed out that not all strategies pursued or recommended fall neatly into one of the quadrants, and some are too vague to be classified. (In India over the last decade, due to over-liberalization of the capital account, exchange rate management, or firefighting, has taken precedence over domestic monetary policy goals, and one would be hard pressed to decide where to slot the different policies the Reserve Bank of India has pursued.)

Former US Federal Reserve chairman William McChesney Martin could be classified as pre-emptive based on discretion, going by his oft-cited punch line "my job is to take away the punchbowl just as the party gets going", but without any specific rule to do so. However, towards the end of his long term (1951-1969), when the economy was overheated due to Vietnam war spending and pressures to keep unemployment low, the Martin Fed very badly failed to take away the punchbowl. The result was the 1970s stagflation, the worst decade for the US and the world economy since World War II.

Whether the late 1960s policies were due to insufficient autonomy for the Fed, or its failure to follow a rule, or its failure at that time to understand that tolerating some inflation will not sustainably reduce unemployment, is for monetary historians to ponder over.

During the 1970s, monetary policy stumbled along, with both inflation and unemployment rising, and central banks the world over paying more attention to money growth. When inflation crossed into double digits in 1979, as part of a policy of inflation control, a money growth rule was tried briefly from October 1979 onwards, under the newly appointed US Fed chairman Paul Volcker. While inflation was brought down successfully, the money growth targeting part of the package proved to be a disaster and was stopped in mid-1982. About a year later, the Bank of Canada, which had also adopted an M1 growth target to indirectly control inflation, gave it up. Then governor Gerald K. Bouey explained the policy change to Parliament by stating "we did not abandon M1; M1 abandoned us".

Volcker was against rules. Nevertheless, he was staunchly against inflation, as Friedman was, and his instincts were to tighten pre-emptively, to head off either inflation or an overextended financial sector. He belongs very much in the top right quadrant: pre-emptive, based on discretion.

After money growth collapsed in the early 1980s, central banks returned to discretionary policies. The Fed based its decisions on early warning financial variables (commodity prices, the exchange rate and, above all, the yield curve) and the strength of the expansion and inflationary pressures, without explicitly targeting them. Targeting nominal gross national product (GNP) as a substitute for money growth was considered, but GNP data come out with a lag and targeting it is easier said than done. Purists complained about the lack of a rule, and there was general unease about the absence of a nominal anchor to control inflation. However, the gradually disinflating economy

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performed fairly under Volcker, and from 1987 onwards under Alan Greenspan. As Benjamin Friedman of Harvard University put it, "In the real world it is hard to quarrel with success."

DIT as a policy evolved against this background, starting with the Reserve Bank of New Zealand in 1990. It was followed by Canada in 1991 and by the UK in 1992. As of 1999, it was pursued by 11 central banks, and another dozen or so joined the bandwagon this decade.

For the US, the current Fed chairman Ben Bernanke along with Fed governor Frederic Mishkin in 1997 recommended in *The Journal of Economic Perspectives* that DIT be adopted as a rule, in lieu of Greenspan's then discretionary policies. However, Bernanke's interest rate cuts in September 2007, to alleviate financial distress, when inflation was rising, violated a DIT rule. Greenspan could be classified as discretionary DIT, adjusting policy as needed to other considerations. Many would say Greenspan did not have a policy beyond bailing out Wall Street biggies. That is a separate matter.

The pros and cons of DIT versus the famous Taylor rule proposed in 1993, and whether rules can be followed at all, need to be discussed in depth. The main conclusion one can draw from the evolution of monetary policy during 1980-2000 is that in giving up money growth, central bankers and economists also ignored a crucial aspect of Milton Friedman's world view: the need to be pre-emptive. As the proverb goes, the baby got thrown out with the bath water.

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inclusive growth means a comprehensive growth in all respect- vertical and horizontal encompassing every thing and every one without ommitting any thing and any one.

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