Should we raise the inflation target?

Grégory Claeys, Research Fellow, Bruegel
Bruegel-Kobe conference on ‘Europe And Japan: Monetary Policies In The Age Of Uncertainty’, Brussels, 2 October 2017
Issue: Secular decline in the neutral rate

Neutral interest rate estimates $r^*$ (%)

Source: Holston, Laubach, Williams (2016)
Consequences for the conduct of monetary policy

Median FOMC members’ policy rate predictions for the long run (%)

Taylor rule for the ECB with constant & time varying r* (%)

Source: FOMC via Bloomberg

Source: Claeys (2016)
Rate cuts & business cycles since the 1950s

Federal Reserve Bank

Deutsche Bundesbank and ECB

Bank of England

Bank of Japan
So should we do it? Pros and cons

**Pros**

- Avoid falling to ZLB in the first place
- Market can clear at a lower real rate ➜ more policy space.
- Rely less on UMP:
  - QE effects uncertain & more difficult to calibrate given relative novelty
  - QE politically controversial in EZ ➜ delay ➜ suboptimal policy
  - Negative rates: less space given cash
  - Potential side effects of UMP on financial stability & inequality
- Cost of higher inflation smaller than we thought (Nakamura et al, 2017)
- Transition: windfall for debtors ➜ help solve current debt overhang

**Cons**

- Higher target could damage credibility of CB and dis-anchor expectations permanently.
- Change in expectations could be slow. In that case would not increase ability to lower real rates.
- With 2% agents behave as if no inflation. Higher level could revive indexation of contracts and 2\textsuperscript{nd} round effects.
- Permanent or long-lasting change for what might be temporary problem (uncertainty around neutral rate estimates)
- Transition: hurt holders of bonds and non-indexed assets ➜ financial stability risk?
Conclusions

• Personally agnostic about it: more research needed
• We shouldn’t dismiss idea in principle
• Risks seems overemphasized
• Also experiences of changes around the world:
  o Canada: target reviewed every 5 years
  o UK: target fixed every year, revised in 2003
  o Japan changed target in 2012 and 2013
  o US only adopted formal target in 2012
• In EZ: Target not set in stone/defined by ECB itself
  o Time to reassess if target still suitable in case of a fall in neutral rate from 2 to 0-1%
  o Audit of the strategy possible as in 2003 (during which 2 pillar strategy was modified and definition of price stability clarified)