



Rethinking the Inflation Target

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Past and future of the ECB monetary policy

Speech by the ECB Vice-President Vitor Constâncio, Valletta 04-May-2018

Talking about the possibility of changing the inflation target:

“Notwithstanding this [the problem of credibility loss], I would have no theoretical objection to a mild correction as proposed by many economist.”

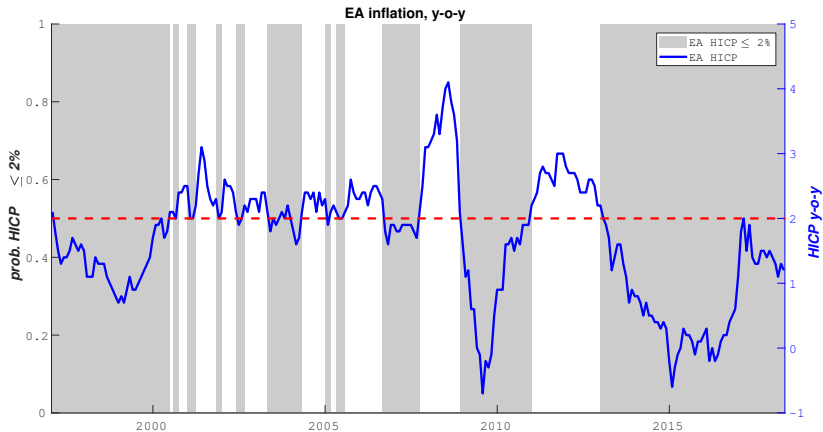
Also cited FED former President Janet Yellen, June 2017:

“But I would say that this is one of the most important questions facing monetary policy around the world in the future. And we very much look forward to seeing research by economists that will help inform our future decisions on this.”



Price stability mandate

A quantitative definition



- For many central banks inflation is stabilized at 2% level
- ECB target: y-o-y HICP below, but close to 2%



Why do we target inflation?

- Why not output or employment?
 1. Intellectual support from New Keynesian models
 2. “Divine coincidence”
- Advantages of stability
 1. Allocating resources more efficiently
 2. Reducing inflation risk premia in interest rates
 3. Preventing an arbitrary redistribution of wealth
 4. Contributing to financial stability



Why do we target a positive inflation level?

- Why not a zero level?
 1. The two zeroes problem ([Krugman, 2014](#))
 - Nominal interest rates cannot be negative
 - Reluctance in cutting nominal wages
 2. HICP inflation might overstate true inflation
 3. Addressing inflation differentials in the euro area
- Why not a negative one?
 1. Average interest rates would be negative
 2. Investing/lending?



Why do we target a 2% level?

Target did not come via a particular scientific process
([Krugman, 2014](#))

However:

1. Consensus among policy-makers that inflation should be very low
2. Even low, sufficient to provide a cushion to make ZLB unimportant
3. Low danger of low inflation (perceived)



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Which alternatives?

Consideration:

- A change in the target might undermine the CB's credibility

Proposal:

- Higher inflation target ([Blanchard et al., 2010](#); [Ball, 2014](#))
- Price level target ([Svensson, 1999](#); [Williams, 2017](#))
- Temporary price level target ([Bernanke, 2017](#))



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Higher inflation target

Proposal for a 4% target: ([Blanchard et al., 2010](#); [Ball, 2014](#))

- Pros
 1. Avoiding the zero-lower bound ($i^* = r^* + \pi^*$)
 2. Give more room to counteract negative shocks
- Cons ([Mishkin, 2011](#))
 1. Force society to bear the cost of higher inflation all the time
 - Inflation is distortionary (tax system is not inflation neutral)
 - Lowering holding of real money balance
 - Greater dispersion of prices
 - Redistribution of wealth
 2. Hard re-anchoring inflation expectations at a different level
 3. Theoretically suboptimal



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Higher inflation target (cont'd)

Evaluation:

- Requires an in-depth costs and benefits analysis.
- However is difficult to quantify the risks of hitting the ZLB
 1. Challenging to establish the ZLB hitting frequency
 2. RE in NK models might underestimate the effects
 3. Absence of inertia



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Price level target

Permanent: long-run 2% inflation target – price trend at 2%

- Fully consistent with price-stability mandate
- “Make-up policy” implying “lower-for-longer”
- Flexible short-run target
- Problems related to supply shocks (“bygones”)

Temporary: 2% inflation + ZLB conditions

- Does not require a large change in existing policy
- Preserving actual price stability
- Avoiding problems related to supply shocks



Thoughts and conclusions

- Central bank's loss in credibility main issue
 1. V. Constâncio addressed this point
 2. [Mishkin \(2011\)](#)'s argument
- Rare events vs secular stagnation ([Summers, 2015](#))
 1. Rare event case, costs might be higher than benefits
 2. Secular stagnation materializes, CBs should be prepared

Agree with J. Yellen:

[“this is one of the most important questions facing monetary policy around the world in the future.”](#)


CBs must prepare for the next storm [Williams \(2017\)](#)



THANK YOU



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