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What Inflation Targeting Means in a Credit Crunch

We are in a global credit crunch and a large share of the world describes its monetary policy regime as inflation targeting (Rose, 2007). Thus it makes sense to ask what kind of monetary policy is implied by inflation targeting in a credit crunch. I will argue that the answer is not simple because it depends on what one means by inflation targeting. However, the answer may greatly matter for how fast we will work our way out of the current problems.

At the risk of oversimplifying, I will draw a contrast between two version of inflation targeting: strict and flexible. The prescription of *strict* inflation targeting is to maintain the inflation rate as close as possible to the target. *Flexible* inflation targeting, by contrast, explicitly acknowledges the monetary authorities' concerns about output. It requires the monetary authorities to be transparent about the way they intend to bring back the inflation rate toward the target in a way that is consistent with their objectives in terms of output (Svensson, 1999).

One could argue that real world inflation targeting regimes are somewhere between the two. They are nominally strict (since they specify explicit objectives for inflation, not for output), but with the understanding that the monetary authorities do care about the output consequences of the projected path of convergence of inflation to the target. One problem with this compromise is that it may give the misleading impression that the difference between strict and flexible inflation targeting does not really matter. This may be true to some extent in normal times, but the two versions of inflation targeting lead to quite different policy prescriptions in a credit crunch. So a lot depends on where exactly between the two conceptions of inflation targeting central banks really are.

Let us start with flexible inflation targeting. My understanding of flexible inflation targeting is that it would require the monetary authorities to *overshoot* the target in a credit crunch. This results directly from the fact that inflation is a relatively painless way of deleveraging.[1] Inflation reduces the real burden of debt, or equivalently, inflates the nominal value of equity.[2] To the extent that there is a larger number of debtors who are financially constrained in a credit crunch than in normal times (this is the definition of a credit crunch), the marginal return of increasing inflation in terms of output should also be higher. If the inflation rate must be equal to the target

[1] Relative to the alternatives, which involve protracted processes of either repaying or restructuring debts. See Jeanne (2008a,b) for models that focus on the deleveraging role of monetary policy.
[2] This of course assumes that debt is in domestic currency and of a reasonably long maturity, which is not the case in many emerging market countries.

on average, it follows that it should be higher than the target in times of credit crunch, when the marginal return on inflation is higher. I am not sure how high the inflation rate should be in the U.S. now, but I would not be shocked if it had to be in the 5-10 percent range (say 6 or 7 percent). This would be enough to reduce the real burden of outstanding debt by 20 percent in 3 years (enough, for example, to rebuild a comfortable level of equity for homeowners with zero equity).[3]

By contrast, strict inflation targeting would imply that the monetary authorities do not let the inflation rate fall below the target in a credit crunch, i.e., that they avoid deflation. Strict and flexible inflation targeting both prescribe to avoid deflation but otherwise they are quite different. There is a big difference between not letting inflation fall below 0 percent and actively pushing it up to, say, 6 percent.

Which version of inflation targeting should we prefer? The answer is not obvious, because there are problems with both strict and flexible inflation targeting. The main problem with flexible inflation targeting is that higher inflation may compromise the long-term credibility of the framework. Wouldn't nominal expectations lose their anchor and long-term interest rates increase to levels that hurt the very borrowers that we want to help?

This is certainly a risk, but overemphasizing it would betray a lack of confidence in the very concept of inflation targeting. One important claim that supporters of inflation targeting have made, after all, is that the credibility of the framework is founded on transparency and accountability. An inflation targeting central banker, thus, should be able to explain to the public that in a credit crunch flexible inflation targeting means a higher rate of inflation for a while --- and that inflation will return to the target as the credit crunch is alleviated. I can see that this makes the pedagogy of monetary policy more challenging in a credit crunch than in normal times, but this should not stop central bankers from doing their job.

The prescriptions of strict inflation targeting raise some problems too. First, it shifts the burden of stabilization on other policy tools that may be less efficient---the experience of Japan since the early 1990s is certainly not very encouraging for those who believe in the power of fiscal stimulus. Second, strict inflation targeting makes it more likely that the economy will indeed fall in a liquidity trap, and will make the exit more difficult. As the literature on Japan in the 1990s has convincingly argued, extricating an economy from a liquidity trap requires the central banker to convince the public that he is not scared of overshooting the target (what Krugman, 1998, called "committing to be irresponsible"). This means, essentially, convincing the public that he is a flexible inflation targeter, not a strict one. Finally, strict inflation targeting has credibility

[3] See Doepke and Schneider (2006) for estimates of the wealth redistribution that would be caused in the US by a moderate inflation episode.

problems of its own, in particular the political pressure to abandon inflation targeting if this regime turns out to be too costly for real economic activity.

On balance, the risks associated with strict inflation targeting seem much scarier. I would strongly support the flexible version of inflation targeting.

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