

Targets for Monetary Policy: Inflation, Exchange Rates, and Others

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1. Introduction

It is well known that most leading central banks have been, over much of the past 15-20 years, conducting monetary policy according to some variant of inflation targeting, implying that maintenance of a low and stable overall inflation rate is (in principle) the predominate objective. Prior to the financial crisis of 2008, this approach was much favored by academic monetary economists, as well as central bank officials and economists. The intensity of the crisis and our continuing slow pace of recovery have served, however, to diminish support for inflation targeting (IT). Quite recently, as a possibly related matter, there has been an explosion of news items concerning the management of exchange rates, those of China and Japan being especially prominent, and with concern raised by the possibility of widespread trade wars of the “beggar thy neighbor” type, somewhat like those that contributed greatly to the disastrous severity of the Great Depression of the 1930s.

2. Inflation Targeting

With respect to IT, cogent discussion and debate of its merits and demerits obviously require agreement as to what is meant by the term. In the original version pioneered by the Reserve Bank of New Zealand and Bank of Canada, the idea was that the central bank should keep a particular measure of inflation within a specified (low) range as the sole operational objective of monetary policy. This position did not

imply an indifference to employment and output behavior, but implied instead a belief that the best way for a central bank to contribute to sustainable performance for these real variables is by focussing on the avoidance of inflation. Gradually, however, academic writings came to be expressed in the form of rules for interest-rate management of the Taylor type that includes the output gap, as well as the inflation rate (relative to its target value), as an additional variable that the policy interest rate should respond to. In this version it becomes possible for too much weight to be assigned to the gap measure, which could be highly inconsistent with the original idea of IT.

3. Criticism

Several writers, such as O’Driscoll (2009), have criticized Federal Reserve performance over several years leading up to the crisis and attributed the deficiencies to its alleged practice of IT. But the main aspect of this criticism is the practice—described by Greenspan (2002)—of not “bursting asset bubbles” during their expansion period while by contrast acting aggressively to prevent or (at least reduce) asset-price deflation. But policy behavior of this type is not IT, this is something that the Fed was doing that was disapproved by leading proponents of IT!¹

Indeed, John Taylor (2009) has severely berated the Fed for contributing to the crisis by its departure from the prescriptions of the epitome of an IT rule, the Taylor Rule—a departure that encouraged

1. O’Driscoll also criticizes IT focus on consumer price inflation, which leads to overproduction of consumables relative investment goods, when “productivity changes were putting downward pressure on final goods prices” (2009, p. 177).



excessively loose monetary policy over 2003-2005.

In this regard, I would agree in part with Taylor's criticism but would argue that the primary root of the crisis was a macroeconomic imbalance² that required correction, namely the housing price boom. This imbalance was largely brought about by deliberate government action designed to stimulate homeownership even among—especially among—families that could not afford it.³ This sectoral imbalance was turned into a macro collapse by unwise regulations and practices in financial markets that led to a freezing-up of the latter. In that regard numerous practices of private enterprises in the financial industry were appalling, but again much of the rot can be traced back to an unwise governmental framework; one prominent example being regulations that gave undue influence (and counterproductive incentives) to a few credit-rating firms. The point, of course, is that these various failures had little if anything to do with monetary policy in general or IT in particular.

On the other hand, I would myself argue that the most prominent form of a typical IT policy rule, as described above, has a weakness stemming from its inclusion of the output gap as a second target/indicator variable to respond to. In particular, measurement of the “gap” requires measurement of the “natural rate” of output; but the latter is an unobservable and unmeasured variable that is conceptually different for every different specification of price-adjustment behavior used in the adopted macro model. And the price-adjustment relationship is arguably the single weakest and most-disputed portion of any macro-econometric model! For this reason, among others, I have long believed that use of the change⁴ in aggregate nominal spending—i.e.,

the change in a refined version of nominal GDP—would represent a more sensible combination of inflation and real-variable measures than is provided by the two variables of the traditional IT rule.⁵

4. Exchange Rates

Quite recently the media have been full of accounts of public, institutional, and congressional concerns over exchange rate policy that seem to me to be appallingly misguided. Of course, Chinese unwillingness to let the value of the Renminbi (RMB) float upward in value is unhelpful to us and to other nations. But (i) even a large appreciation of the RMB would make very little difference in the balance-of-payment deficits or surpluses of concern. (ii) Also, what is typically regarded as exchange-rate policy is the management of nominal, not real exchange rates, although it is the latter that is of economic importance. (iii) Furthermore, the discussion rarely if ever recognizes the fundamental point that exchange-rate policy and monetary policy are, at least in an economy without extensive capital controls, in fact just two sides of one coin—two aspects of one policy. In light of these and other basic realities, it seems that the media emphasis on the RMB exchange rate suggests that congress and the administration are more concerned with posturing for voter popularity than with attempting to actually accomplish improved economic performance.

It is in any event highly unlikely that the Chinese can be persuaded to make a fundamental change in their economic policies in order to make matters easier for the U.S. and the rest of the world. More generally, i.e., for countries with market economies and democratic political systems, I have previously indicated that “... some critics are generally inclined

2. O'Driscoll would, I think, agree with this contention.

3. See Pinto (2010) and Wallison (2010).

4. The changes mentioned here are all fractional (or percentage) changes.

5. This suggestion is operationally very close to that of Orphanides (2003) and is accordingly in the same general type as that of Levin and Williams (2003).



to view most efforts toward international coordination as thinly disguised attempts by national governments ... to get other nations to take actions that might rescue them from the consequences of their own unwise but politically advantageous domestic policies” (McCallum, 1996, p. 237). In the matter at hand, a more effective strategy for the U.S. might be to publicize, in ways designed to reach the Chinese public, the fact that the consumption of Chinese households is an astonishingly small fraction of Chinese GDP (i.e., production). Recognition of this fact might gradually lead to policies that would not be so slanted toward exports, and which would feature arrangements more compatible with a market economy.



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