Comments on Bennett T. McCallum's: Should Central Banks Raise their Inflation Targets?

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McCallum's 8 reasons to avoid a 4% average inflation

Inflation as a tax on money holdings is bad.

Inflation leads to inefficient relative price changes.

Not much inflation is needed as a cushion for monetary policy.

Exchange rates and long term rates remain available.

With modified institutions, interest rates can be negative.

Recognizing a tradeoff between inflation and unemployment would create political pressure for inflation.

Price implications of 4% inflation from 1792 are shocking.

Higher inflation would lead governments to higher deficits.

My main reason to oppose inflation: people quickly see it as "the nation's most important problem"

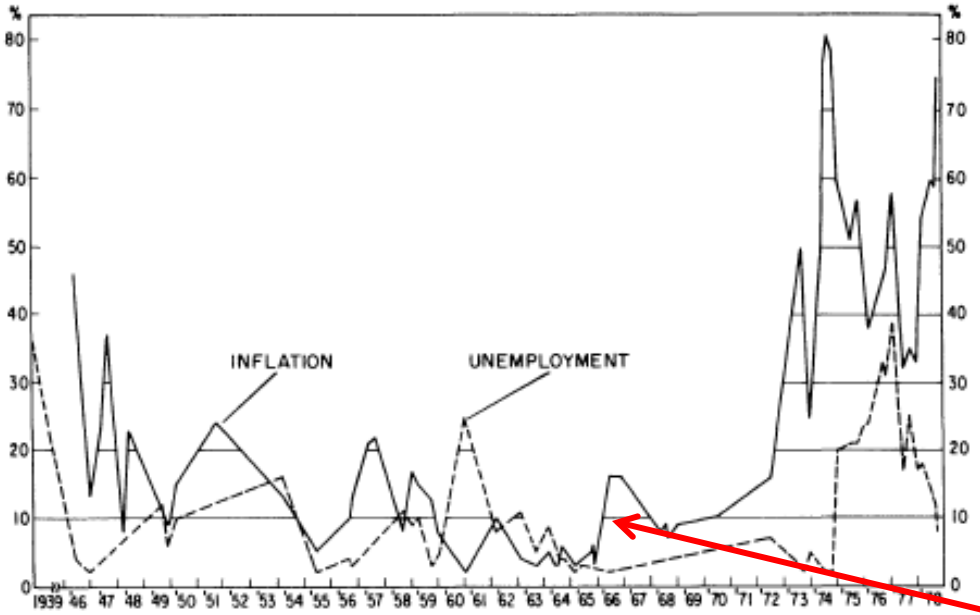


FIG. 1. Inflation, Unemployment as Nation's Most Important Problem. *Note:* Reproduced from *Gallup Opinion Index* (November 1978), Number 160.

From Fischer & Huizinga, JMCB, 1982.

See also Di Tella et al. AER, 2001.

Rises from
6 to 16%
as PCE inflation
goes from
1.4 to 2.4%

Why?

-Regret at buying after price increases?
-Eroding standard of value?

Inflation is a “bad tax” on money holdings

Blanchard, Dell’Aricca and Mauro (2010) say:

> “The inflation tax is clearly distortionary, but so are the other, alternative, taxes.”

But, it is probably a “worse tax” because it raises little revenue and taxes an “intermediate good.”

On the other hand, the standard welfare gains from lowering inflation to reach the Friedman rule seem modest.

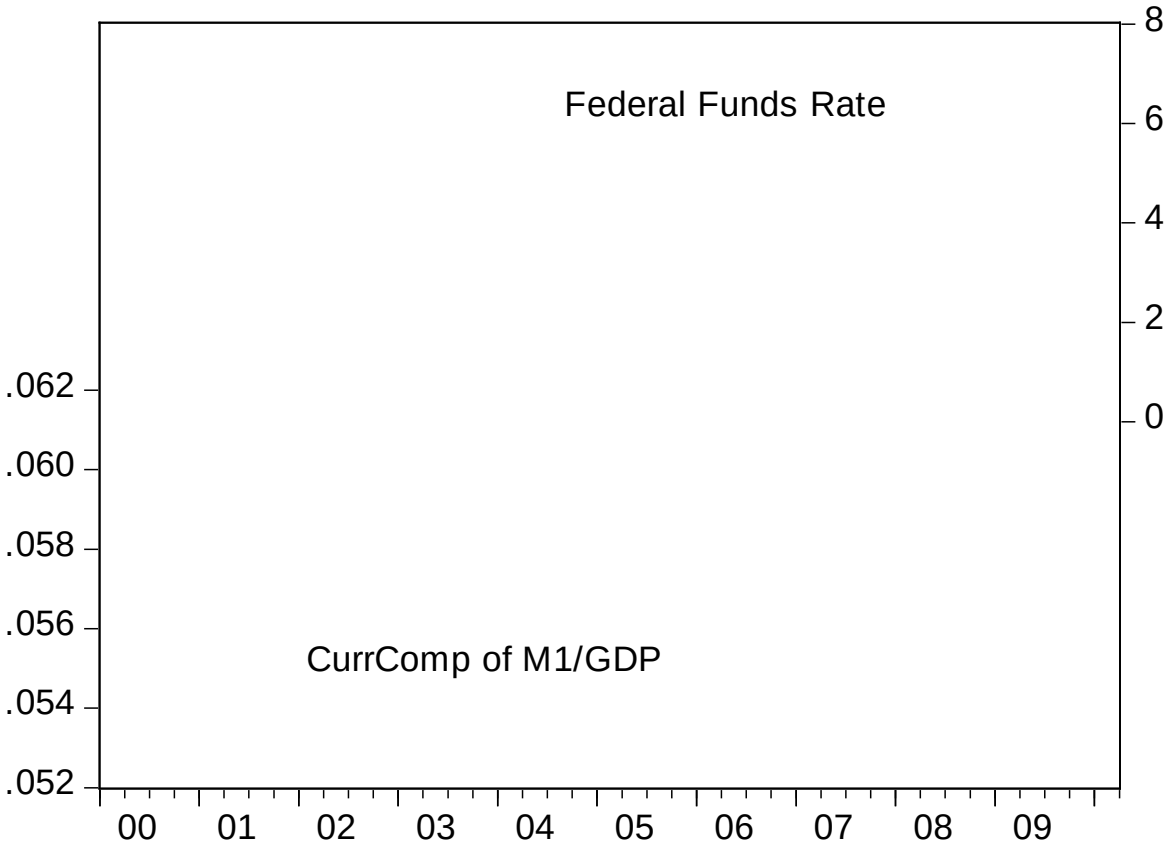
Budget constraint: $A_{t+1} = (A_t - P_t C_t - M_t)(1+i) + M_t$

One dollar of money costs i in future assets
One dollar of consumption costs $(1+i)$ in future assets

$$dU = U_C \, dC + U_{M/P} \, d\, M/P = U_C \, [dC + (i/(1+i)) \, d\, (M/P)]$$

Cut in Federal Funds rate from 5.25% in 07:2 to “0” in 09:2 raised currency holdings by .006 of GDP or about 87 billion dollars.

Currency in the hands of the public and the federal funds rate



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Supposing i is linear in M, this gives $2.2 billion of consumption equivalent.

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where A_t are total assets at the beginning of t implies that the marginal utility of a dollar of additional non-interest bearing money must equal the marginal utility of $i/1+i$ dollars of consumption

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Not much inflation is needed as a cushion for monetary policy

Schmitt-Grohe & Uribe (2010) show that with optimal policy, log preferences, and a target inflation rate of -.4 %

The standard deviation of interest rates at annual rates is .9% so ZLB bites rarely with a growth rate of 1.8% and a discount rate of 1% (they prefer 3%).

Their cushions (i.e. steady state nominal rates) equal 2.4% (or 4.4%).

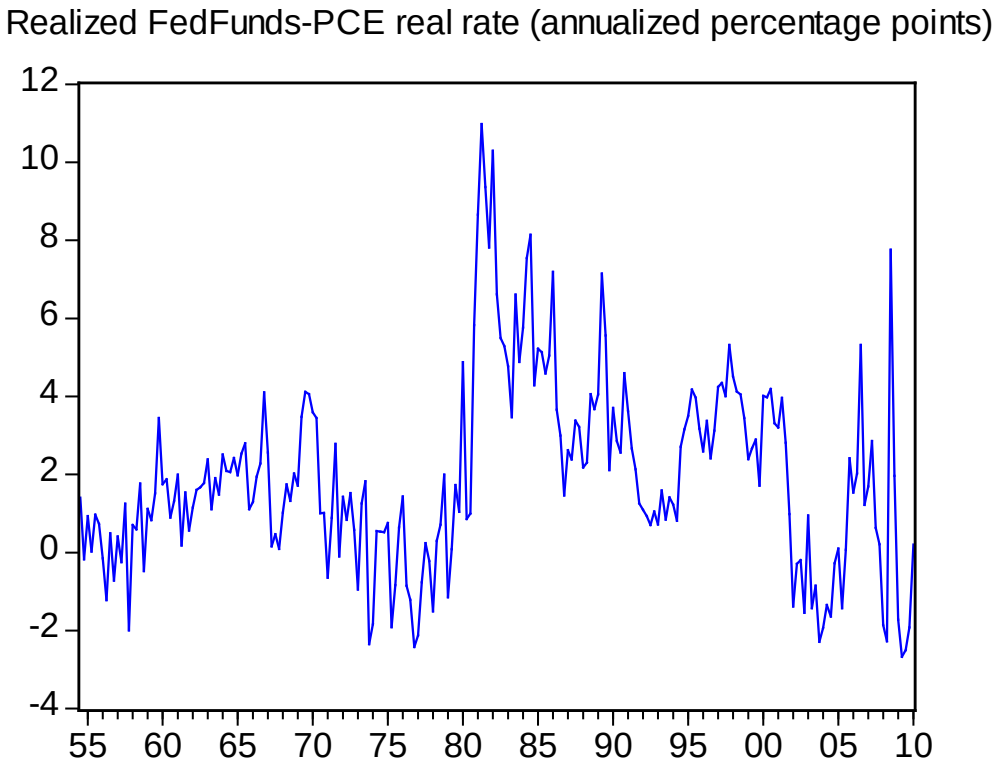
Concerns:

- Optimal policy with commitment is very clever.

- Suboptimal policy does require larger cushions (to offset mistakes).

- Billi (2010) shows lack of commitment can justify appointing a 17% inflationist.

- These calibrations assume underlying real rates of interest of 2.8 - 4.8% but,



So there may be extensive periods where (as suggested in Summers (1991)) the "natural real rate" is close to zero – even if we cannot get this out of standard models.

What is more, transition between R^* regimes may be abrupt.

Exchange rates and long term rates remain available

Clear from yesterday (and Greenwood, Hanson and Stein (JF 10))that maturity interventions have some effect.

Concerns:

- Size of effect?

-Buying high with the hope to sell low is not the ideal “risk”.

- Exchange rates affect international relations and recent realignments have led to great concern – central banks cannot do this “independently.”

With modified institutions, interest rates can be negative

McCallum is drawn to the Buiter's idea of eliminating currency.

Concerns:

- About 10% of families were unbanked in the 2007 Survey of Consumer Finances.

- Many of these claim that banking would be expensive for them
  – how should the government enter this business?

- Convincing voters that they should give up their currency so that they can earn less on their savings accounts may be difficult.

Recognizing a tradeoff between inflation and unemployment would create political pressure for inflation

McCallum gives the idea that there is no long run tradeoff between inflation and unemployment credit for central bank independence and the taming of inflation.

My tendency is to ascribe the conquest of inflation to the realization that voters wanted this.

Higher inflation would lead governments to higher deficits

Does McCallum mean the trivial “deficits” that would actually be financed by seignorage?

Or is there a reason to fear even larger deficits?

I would have thought that deficit hawks would dislike reaching the ZLB, because this promotes deficit spending.

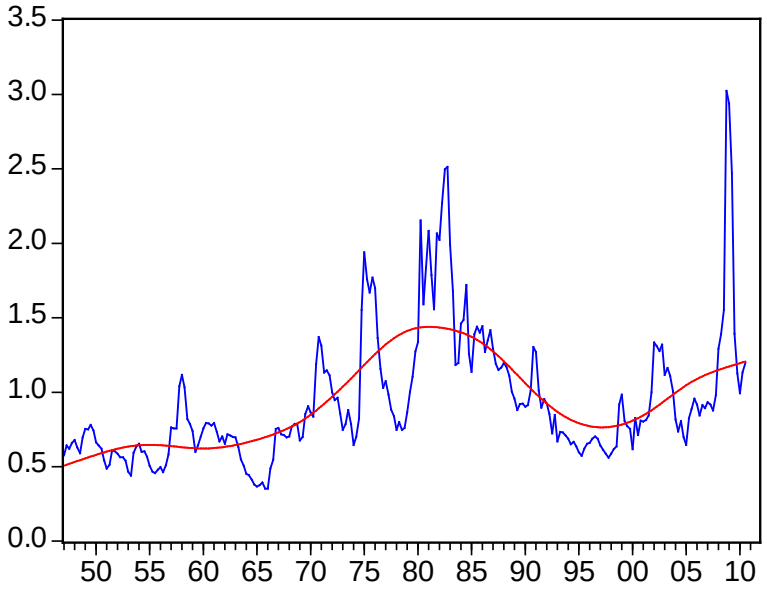
A tentative “search for yield” argument for some inflation

Rajan (2005) notes that low interest rates lead financial market participants to “search for yield” by investing in riskier assets.

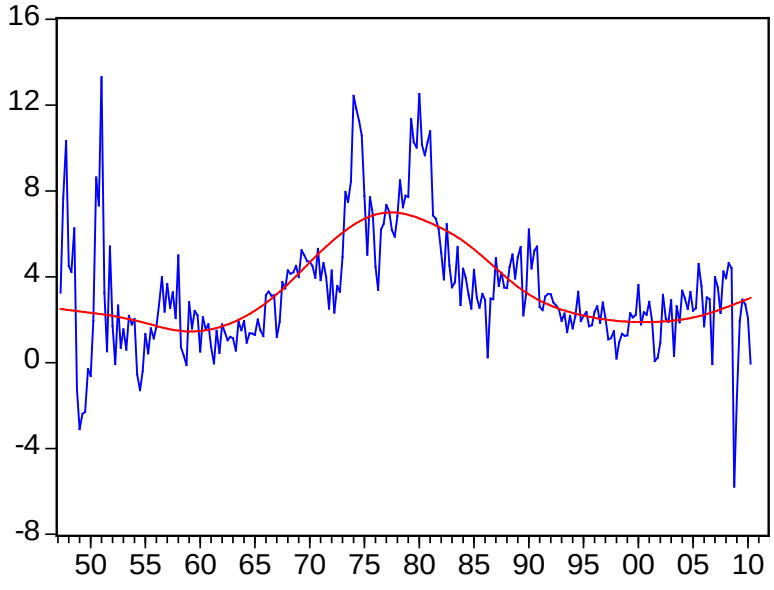
Couldn’t a low average inflation rate make this “search” permanent and lead to more frequent and more problematic “credit bubbles.”

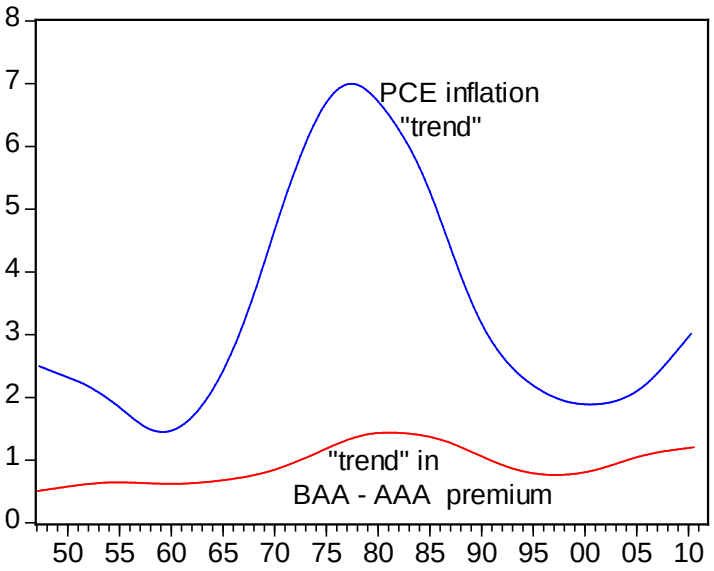
Tiny bit of evidence: Spreads between Moody’s BAA and AAA corporate bonds appear to narrow when inflation is lower.

Moody's BAA-AAA yield premium and its acyclical "trend"



PCE inflation and its "trend"





Correlation=.78

For more sophisticated – if a bit different – evidence on this see Greenwood and Hanson “Issuer Quality and Corporate Bond returns” 2010.

Conclusion

Great breadth of arguments for low inflation.

The inclusion of political economy and marketing considerations is particularly welcome.

I end up more optimistic than McCallum that “politics” should and will stop inflation from skyrocketing.

And less optimistic than McCallum that we will be able to get high welfare with a 2% target.