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Renouncing stable prices

A promise of higher inflation from central banks might spur the recovery—if it is believed
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TODAY'S central bankers are like golfers missing a favourite club. Since cutting short-term interest rates almost to zero early in the global recession, they have been swinging with clumsier implements. Quantitative easing (QE), printing money to buy bonds, has come out of the bag most often. But QE involves meddling in markets on a worrying scale. Central bankers have therefore been honing a new strategy: attempting to boost confidence by providing “forward guidance”—giving a clearer steer on their future plans. New research by economists at the Federal Reserve provides tips on how central banks can deploy this technique more effectively. Their work may provide guidance of its own, to how the Fed’s policy will change in coming months.

The new study, by William English (head of the Fed’s monetary-affairs division), J. David Lopez-Salido and Robert Tetlow, begins by surveying the recent evolution of Fed policy. Since short-term interest rates fell to zero, the Fed has leant ever more heavily on forward guidance. Improved communication was a priority even before the crisis, the Fed paper notes; in 2007, for instance, the Fed began publishing economic projections to give markets a better explanation of why it took certain steps. But the crisis accelerated the reliance on communication as a means to stimulate the economy.

Early in the recovery the Fed said interest rates would remain near zero for an “extended period”; it later tied eventual rises to specific dates (“mid-2013”). Now both the Fed and the Bank of England link increases to economic conditions. The Fed says it will not raise rates until unemployment has fallen at least to 6.5% (it was 7.2% in September), provided that short-run inflation is no higher than 2.5%. The new paper suggests that this formula should be amended.

The authors point out the main difficulty in using talk about the future to perk up growth. For forward guidance to have any impact on the economy, markets must believe that rates will stay close to zero even as growth and inflation pick up, thus making current borrowing and investment more attractive than they otherwise would be. That puts prudent central bankers in an awkward position: to get the economy moving they must persuade markets that they will tolerate higher inflation. Such a situation is not as far-fetched as it sounds. Very low inflation could be the harbinger of deflation—falling wages and prices—which discourages investment. In a 2013 paper Lars Svensson of Princeton University, who is also a governor of Sweden’s central bank, argued that inflation below the central bank’s target generates unwanted unemployment, even if deflation is avoided.

As the research from the Fed officials points out, the case for higher inflation is most straightforward at the “zero lower bound”, where short-term interest rates are close to zero. Economists reckon firms respond to “real”, or inflation-adjusted, interest rates. In normal times real rates generally fall with nominal rates, because inflation does not change much in the short run. But when nominal rates approach zero a central bank can keep ratcheting down the real interest rate by convincing the public to expect higher inflation. At a nominal interest rate of zero, an expected inflation rate of 1% yields a real interest rate of -1%. Higher inflation pushes the real rate still lower (see chart).

Never trust a central banker
The problem is that central bankers have an incentive to renege on promises to allow higher inflation, rendering them less credible. Making the promise, if it is believed, should boost economic activity. But once the economy is chugging along, the temptation is to try to get the best of both worlds, by raising rates before prices go up. And if markets doubt that central banks will really embrace higher inflation, the paper argues, then expectations will not adjust and the real interest rate will not fall.

The authors therefore ask how central banks should tweak forward guidance to overcome the problem of credibility. They simulate several different policies to gauge which brings down unemployment the most. A simple commitment to keep rates low even after inflation tops the Fed's current target of 2%, if credible, works wonders. America's unemployment would drop below 6% a year earlier than currently projected, according to their estimate. But such a sweeping pledge may not be believed.

Promising to keep rates low until unemployment reaches a certain threshold—as the Fed is currently—might be more credible, in that it sets a clear limit on the central bank's new-found permissiveness. The authors believe that the Fed's 6.5% unemployment threshold will indeed speed a reduction in unemployment—though not by as much as the straightforward promise to allow inflation to exceed 2%. A 5.5% unemployment threshold, the paper finds, performs even better.

A more radical option would be to raise the Fed's target for inflation from 2% to 3%. That would reduce unemployment faster than setting unemployment thresholds, the paper finds, although it would presumably stir up even more opposition among monetary hawks. The authors also assess a “nominal income” objective, which would target growth in GDP in dollar terms (sometimes called nominal GDP). This would yield the fastest and largest drop in unemployment of any of the policies tested. Inflation, meanwhile, would stay lower than it would under a 3% target for inflation itself.

For a new goal to work the public must understand and believe it. If markets doubt the Fed's commitment to a 3% inflation target or are confused by talk of nominal GDP, then the new guidance could be counter-productive. Some experts reckon the Fed could be more open to tweaking its thresholds. Jan Hatzius, chief economist at Goldman Sachs, thinks the new research may nudge the Fed into lowering its unemployment threshold from 6.5% to 6.0%. Janet Yellen, the president's nominee to head the Fed from next year, has advocated such an approach. Fore!


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