Beyond Inflation Targeting

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Inflation targeting

- "the public announcement of inflation targets, coupled with a **credible** and **accountable** commitment on the part of government policy authorities to the achievement of these targets" *"full fledged " inflation targeting consists of:*

- absence of other nominal anchors, such as exchange rates or nominal GDP;
- an institutional commitment to price stability;
- absence of fiscal dominance;
- policy (instrument) independence; and
- policy transparency and accountability

The key problem is that

- much evidence has now been accumulated that the globalization of finance has become an underlying source of instability and unpredictability in the world economy.

- price stability, on its own, may not suffice to maintain macroeconomic stability, as it may not suffice to secure *financial stability*.

The idea of equilibrium:
The Savings – Investment Balance

$$Max \int_0^\infty U(c_t)dt$$

Subject to:

$$PC + a_t = wL + ra_{t-1}$$

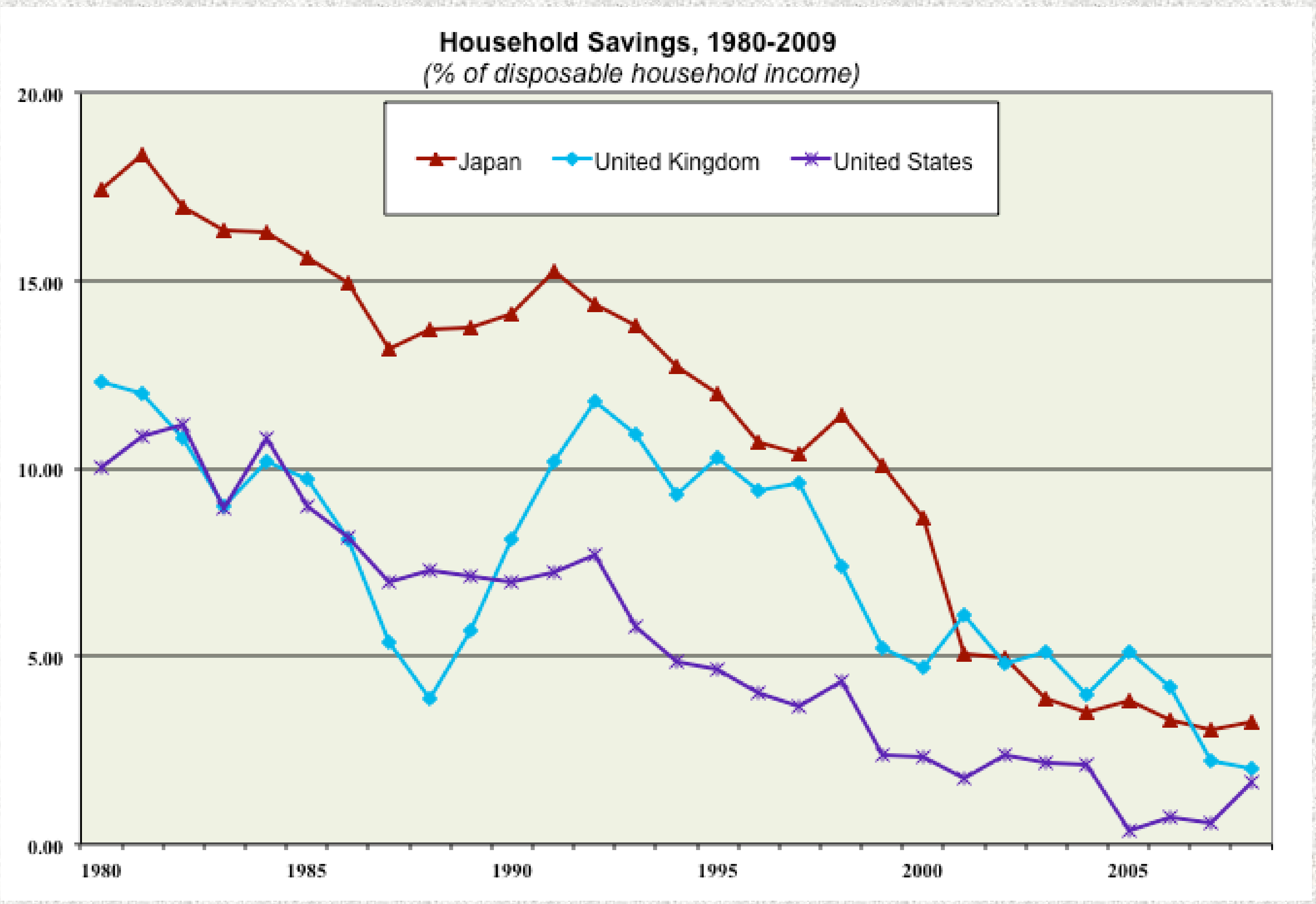
$Q=f(K,L)$

The producer maximizes profits (the difference between revenues PQ and costs of labour and capital, wL ve rK).

Thus, for producers the problem is to:

$$Max\ \ Pf(K,L) - wL - rK$$

a =?= K



Household Savings, 1980-2009
(% of disposable household income)
Japan
United Kingdom
United States
20.00
15.00
10.00
5.00
0.00
1980
1985
1990
1995
2000
2005

- Microfoundations story where investment is passive and savings-driven is far from reality.

- Mathematical elegance of the Hamiltonian arithmetics of pleasure fails to model realities of the economic phenomena.

- Asset manias and bubbles are more than a possibility (Kindleberger)

Macroeconomic Record

the currency crises of the 1990s have underscored the need for *avoiding overvalued* exchange rates.

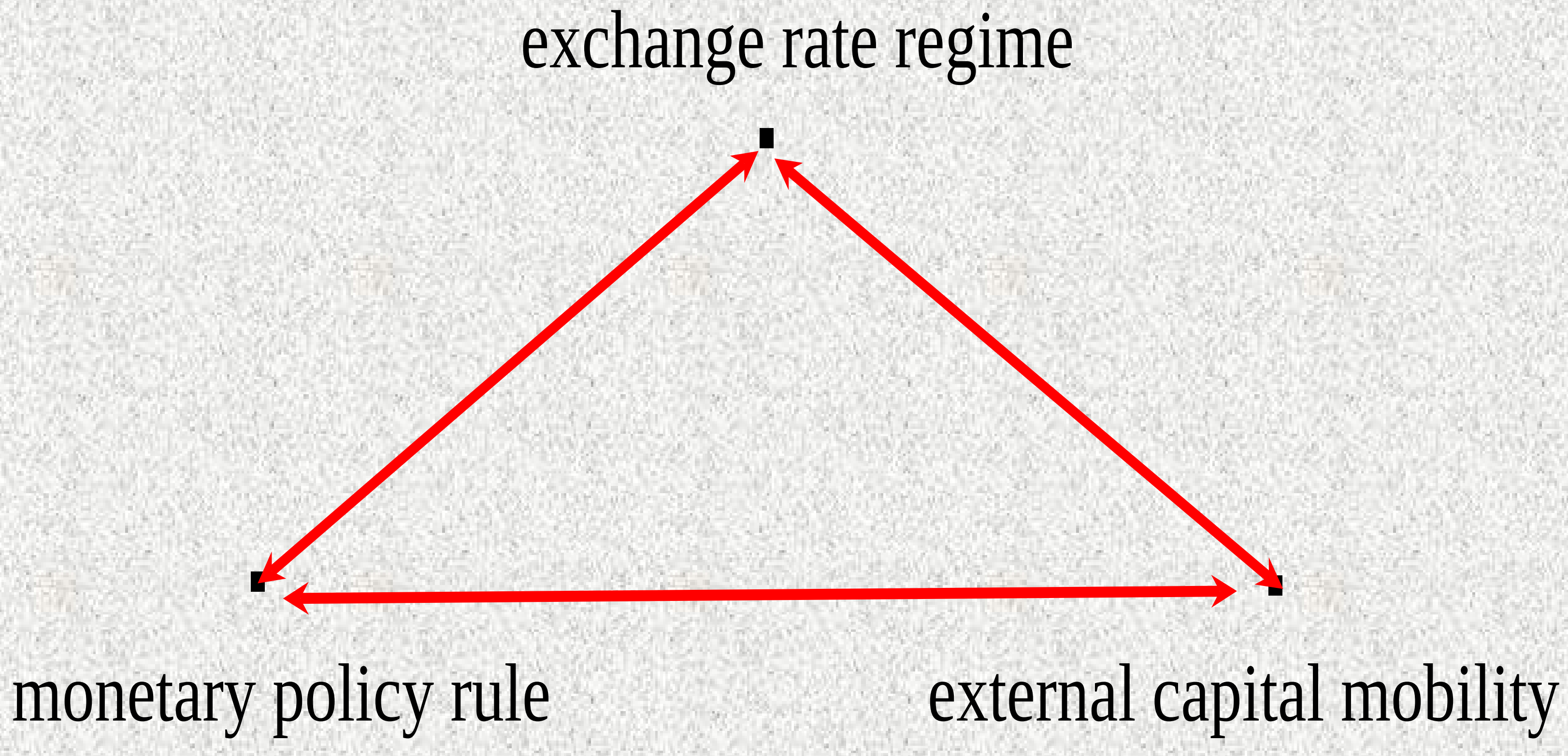
even under flexible exchange rate regimes, the exchange rate may become misaligned, if its actual value exhibits a sustained departure from that rate which is compatible with the *internal and external equilibrium.*

The Un-Holy Trilemma

A Central Bank can choose only two of the following policy regimes:

- exchange rate regime
- monetary policy rule
- external capital mobility

Regard the trilemma in a continuous fashion:



Alternatives to Inflation Targeting

(Gerald Epstein and Robert Pollin, among others)

- *Why target inflation? Employment? Exports? Current account?*
- *Targeting* **real** exchange rate (post crisis Latin American experience, Roberto Frenkel, Jaime Ros, Lance Taylor...)

*Alternatives to the **Instrument***

Use the **Pasinetti Rule** (Setterfield)

Set the interest rate to the rate of growth of **labor productivity**

Why targeting “as low as possible rate of inflation”?

- Pollin and Zhu (2006) report that higher inflation is associated with moderate gains in GDP growth up to a roughly 8 – 10 percent inflation threshold.
- They found no justification to maintain inflation within a 3 – 5 percent band throughout the middle- and low-income countries.

Lessons, lessons

for a good listener

- not only the domestic, but also the global economy is in need of management and regulation

- the business cycle is driven by shifts in the savings investment balance

- both the current level of economic activity and growth are driven from demand side with *endogenous* labor productivity growth (Kaldor)

- policy recommendations based on static comparative advantage calculations are misleading and bad advice

- development warrants not doing more of the same thing more intensively, but diversification into producing things up in the ladder of industrialization (Rodrik, Ha Joon-Chang)

•Exchange rate might be in spot market equilibrium but may suffer from *structural misalignment* (Edwards)

•*even under flexible exchange rate regimes*, *the exchange rate may become misaligned*,
if its actual value exhibits a sustained departure from that rate which is compatible with the *internal and external equilibrium*.

- over-obsession with fiscal sustainability while neglecting balance of payments sustainability is a dangerous game

In fact,

- "…the *source of macroeconomic instability* now is not instability in product markets but asset markets, and the main challenge for policy makers *is not inflation, but unemployment and financial instability*".

Akyüz (2006)

“ the argument that ‘this time things are different’ is a statement that can only be made by fools that fail to take any lessons from history...”

Kenneth Rogoff, IMF Chief Economist, 2005