Discussion of

Raising the Inflation Target: What Are the Effective Gains in Policy Room?

By Jean-Paul L'Huillier and Raphael Schoenle

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Roberto M. Billi

Sveriges Riksbank

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Why might the optimal inflation target be low and positive?

- Why should inflation be kept **low**? Inflation is costly.
  - When it is unanticipated, it discourages saving and investment by creating uncertainty about future prices.
  - Inflation is also costly even when it is fully anticipated, causing the economy to operate less efficiently, hampering economic growth and ultimately reducing standards of living.
- Why should inflation be **above zero**?
  - It can be too low for a number of reasons: (1) measurement error, (2) downward wage rigidity, (3) debt deflation, and (4) an effective lower bound (**ELB**) on policy interest rates.
- For an early discussion of these issues from a central-banker perspective, see Billi and Kahn (2008) in the Fed Kansas City *Economic Review*.

When r-star is low, should central banks facing the ELB aim for higher inflation?

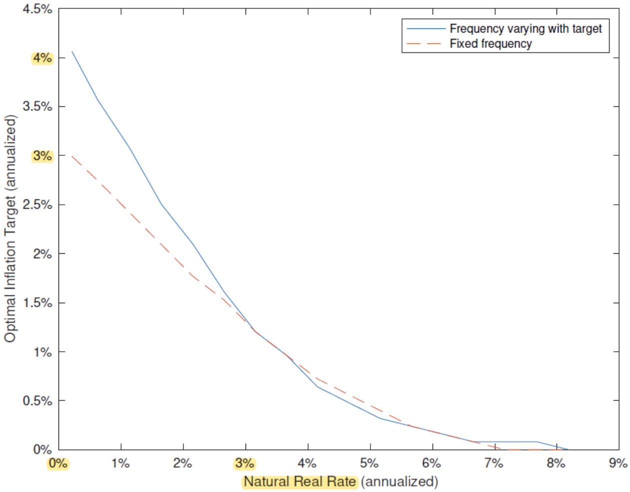
- The **natural rate of interest**, or r-star, is defined as the real short-term interest rate expected to prevail when an economy is at full strength and inflation is stable.
- Measures of r-star, for advanced economies, have fallen from above 2.5% before 2008 to around 0.5% after 2010. That is, r-star may have **declined by 2 percentage points**.
- Some have argued central banks facing the ELB should **raise inflation targets** above 2%, perhaps to 3% or even 4%, to regain the lost policy room.
- But the authors show, importantly, previous studies may have **substantially overstated the potential gains** in monetary policy room from raising the inflation target.

When inflation is high, prices change more frequently and monetary policy becomes less effective

- The authors illustrate, convincingly, raising the inflation target would **steepen the Phillips curve**, which makes monetary policy less effective at stabilizing inflation and output.
  - Related, *price and wage flexibility* can be undesirable if facing the ELB. For an illustration, see Billi and Galí (2020).
- The analysis also suggests, importantly, any loss of monetary potency from raising the inflation target can be avoided by simple rules in which **interest rates react strongly** to deviations of inflation and output from target.
  - But to restore monetary potency, *other policy options* such as forward guidance and quantitative easing are also available.

Key finding, if r-star near zero, the inflation target should be 1% higher just to account for frequent price changes

Figure 7: Optimal Inflation Target



Policy options to "make up" for a lower r-star

- Raising the inflation target could **steepen** the Phillips curve and, *all else equal*, **reduce** the potency of monetary policy.
- The analysis, however, highlights the practical relevance of the **array of policies and strategies** already available to central banks to stabilize inflation **when at the ELB**.