Inflation and effect on US Market

Inflation Targeting

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# Introduction

Without any doubt it can be said that Inflation has been a serious concern of economists through out the world. This issue has been haunting US government and economists time and again. The complexity lies in the very nature of Inflation, this Inflation cannot be suppressed to absolute zero and high inflation rates are also not desirable. (Paul, 2008) Through out our paper we have analyzed the effects of Inflation on US market. How market has been changing and what is the effect of Inflation on changing trends in market. Talking in simpler terms Inflation generally hurts the buying power of people. However it is sometimes useful for people who have invested much in share markets.

Federal reserve tries its level best to maintain Inflation at the rate of 3-5%. The FED has devised various policies and the same would be discussed in the paper. Through out the paper it would be find out what is the perception of people regarding Inflation. People believe in current expenditure rather than saving for future when level of Inflation is high. FED tries to control inflation so that people can also save for future. Many researchers have said that Inflation is important for people investing in treasury bonds and capital markets. With inflation on a rise, it is difficult to curb inflation; it can also result in more and more inflation known as spiral inflation. Therefore it is preferred that government and FED takes steps in advance so that the effect of Inflation on common man can be minimized.

Inflation also has an effect on Time value of money. It is difficult to find the rate of interest when rate of inflation fluctuates a lot. In fact the estimated or real change in the inflation rate is the reason for change in rate of interest while calculating TVM (Time value of money). Inflation also has an effect on the treasury of nations. In America government has formulated TIPS (Treasury Inflation Protected Securities) to ensure the safety of government and to safeguard the rights of people. Inflation also leads to a section of customers to make speculations. There are a section of people that aim at taking benefits of Inflation by investing in high-risk investments. In the paper it would be discussed that how this gives a rise to structural unemployment. Inflation also changes the allocation of Income. The lenders are de motivated when Inflation is high. This is due to the reason that loans are returned back with inflated dollars. This would be discussed in detail that how government and FED keeps a track of market and inflation so that lenders and buyers are not hit in any point of time.

Inflation targeting is an approach that is being used by many countries to maintain the price levels. New Zealand is the first country, which used this approach of Inflation targeting in year 1990. So far more than 25 countries have adopted this approach and this approach has been successful in stabilizing inflation and real economy. The main characteristics of inflation targeting are as follows: -

* A pre determined, discussed and announced numeric target for Inflation
* An implementation of monetary policy in a way so as to forecast Inflation levels
* An increased degree of responsibility and accountability
* A mandate for the price stability and independence
* Targets and accountability for central bank

# 2.0 Analysis

The economy of United States has undergone many structural changes due to inflation. Since 1970’s level of inflation and nominal interest rates have witnessed an inverted U Shaped pattern (rise at 1970 and decline at 1980). The prime reason for this run off inflation was that the economists thought that there was a tradeoff between output and inflation. Following the oil shocks of 1970’s the idea to keep inflation high was strong. Between the periods of 1960 to 1980 the level of inflation has fluctuated from 3% to 13%. In today’s scenario many economists have suggested that US Fed should explicitly target inflation and target on long-term stable levels of inflation. Many economists also believe that US have been successful in achieving a stable price levels therefore inflation targeting must be a policy of US Fed. There are many drivers for inflation targeting; we would discuss all one by one. We would start our discussion with what is wrong in the present regime.

# 3.0 What is at fault in current scenario / regime?

## 3.1 One instrument / tool to manage two contradictory / interlinked objectives

The current monitory policy tools of fed are discount rates, open market operations and reserve requirements. It can be said that FED has the capability to impact the inter bank lending rates and consequently the short term nominal interest rates, at the same time long term nominal rates (that apply to all the economy actors) can also be influenced. At this point worth mentioning is that these interest rates have an influence on an important economic activity ‘the cost associated with borrowing’. The prices levels are supposed to be flexible hence real economy activity are impacted. This ultimately impacts the general price level in the market or inflation. There would be an increased demand in the factors of production, which ultimately results in the high price level and inflation. With the above discussion it can be inferred that US Fed is handling the repercussions of both objectives with same tool. Monetary policy hence seems ill suited to manage the long-term variables of variables (economy variables). The levels of output and unemployment can wrongly be judged and predicted by monetary policy. This reflects that there should be explicit inflation targeting. The credibility of central bank is another such reason for explicit inflation targeting. The policy of Fed and banks is to keep inflation at little above the general prevailing level. This inflation level also raises the expectation of future inflation levels. In regard to Inflation the priority of objectives should be well known in advance.

# 4.0 Arguments for explicit Inflation targeting

There are mainly two basic arguments for Inflation targeting, one has economic connotation and one has political connotation. Inflation targeting does not only make monetary policy more efficient but more democratic also. We would discus both these things here.

## 4.1 Inflation, monetary policy and efficiency

The researchers and economists have believed that monetary policy is much more efficient with Inflation targeting. With a numerical target in mind Fed is always in a better position to manage the expectations of public. The preciseness in the actions and objectives of Fed leaves a little room for public expectations. The Inflation targeting can also help during the time if supply shocks when level of inflation and output moves in opposite directions. At this scenario a good commitment to price stability is the requirement. From the very nature of supply shocks, they are temporary. Hence if Fed and government is in better position to better understand and forecast expectations, they would be in a better position to deal with this position of supply shocks. Central bank doesn’t have to increase the interest rates in an aggressive manner. (Bennett, 2007)

## 4.2 Democracy, Monetary Policy and Inflation

This second relation evaluates the relationship between congress and Fed, people do believe that central bank should be given well defined target in advance so that they can better design their policies. People should have an idea and way to judge, access, evaluate and measure the steps taken by Fed in regards to inflation. This can precisely be done by Inflation targeting. Though the goals and objectives of Fed are always devised by congress, still given the complex nature of objectives Fed often decide that what objectives are to be taken and in which order. (Woodford, 2003) The weights in relation to Inflation and Employment are at discretion of Fed, though it is entirely a subjective matter that this discretionary power is creating good or bad for economy. However people have to say that in the democratic country citizens have right to know what government and Fed have planned for them. Moreover many researchers believe that people are the main stakeholder, hence they have every right to know the steps being taken by Fed. The third issue that prefers Inflation targeting is that it is not easy to judge and measure the performance of Fed. Most of the times it is difficult to answer the questions such as ‘Is 4% inflation good?’ These kinds of questions are always subjective and depend upon the condition of economy and challenges faced by Fed and central banks. (Irineu, 2010)

In summation to above discussion it can be said that the Inflation targeting would at least bring three things in the functioning of Fed, these are: -

* Accountability
* Efficiency
* Democracy

# 5.0 Arguments against Inflation targeting

## 5.1 General view

Though many experts have written against Inflation targeting also, they have to say that it would be tough in the part of Fed and Central banks to work and operate under any pre defined target, as the situation is always dynamic. They have to say that in this era of globalization where multinational companies have establishes themselves beyond domestic boundaries it is not easy to have pre defined goals and objectives. Secondly all three (Congress, Fed and Central Banks) would be under the continuous scrutiny and pressure from public, which can decrease their productivity.

## 5.2 Lost flexibility with Inflation targeting

Many experts and economists have to say that Inflation targeting would make entire structure and functioning of monetary policy more mechanical. It is also possible that the focus of Fed remains in Inflation and other areas are neglected. Some of the questions raised in this regard are: -

* How Fed would be able to respond differently in different scenarios?
* The past history of US Monetary policy is based on its flexible approach and dynamic nature. What is the guarantee that Inflation targeting would not put and end on this?
* How policy makers and government would handle the increase stress from Inflation targeting?
* It won’t be right the fix the thing when it is not broken. The fed has not performed so bad in the past then what is the need to change existing practice?
* There would a reduction in the level of independence enjoyed by Fed, would Fed be able to work and function effectively without this independence?

It can be said that it is too early to decide upon the probable benefits and risks of Inflation targeting, still it can be said that Fed can take a middle approach where by not involving in ‘Strict Inflation targeting’ but still have a framework or target in the mind so that the road map for future is clear. In fact the many things depend upon the definition and scope of Inflation targeting itself. How Fed and people take up Inflation targeting and what each one expects from other party. (Benjamin, 2004)

# 6.0 Empirical evidence and Inflation targeting

The first point to mention here is that none of the evidence is so conclusive, researchers and experts are still divided in the idea of inflation targeting. This field is not very recent and economists have yet to come up with strong empirical evidence that can suggest benefits from Inflation targeting. One thing that was common throughout research work was that those countries, which were looking to reduce the Inflation level, adopted Inflation targeting. However the difference between targeters and non-targeters cannot be done because countries are difficult in so many respects. The economic environment of each country is different and policies are made as per the local environment. However with globalization economies of different countries are becoming more integrated.

Mishkin (2008) has answered a very important question: the relationship between inflation and output, does stable levels of inflation really helps in stabilizing output level. Many experts have believed that answer to this question is affirmative and many countries have helped themselves with stabilizing output by Inflation targeting.

Laubach and Posen (1997) did an interesting study; they compared the country, which have done Inflation targeting and countries, which have not done Inflation targeting. They have compared the targeters such as Canada and New Zealand with non-targeters such as Australia, these countries have somewhat similar economic environment. They also compared the targeters United Kingdom and Sweden to non-targeter country such as Italy. Countries like Switzerland and Germany were also compared in the study. The authors concluded their work that Inflation targeting helped countries in reducing inflation levels.

Creel and Hubert’s (2003) have done a study in classical way in which they have compared the performance of countries before and after the adoption of Inflation targeting. In general it was found that countries were benefited with Inflation targeting. The study has shown that with Inflation targeting countries can also make some calculated risks with regard to monetary policy. The policies of countries works in framework and the future can be predicted in a better way.

In United States, FOMC (Federal Open Market Committee) has said that US fed should have an inflation target of 1.7% to 2% however they have not shown any preference of explicit Inflation targeting. It was January 25th 2012, when chairman Ben Bernanke set an inflation target of 2%. This brought Fed in line with many other central banks of world. Till know this has been seen as a good step and experts have people have supported this move.

# 7.0 Problems with establishing Inflation targeting

We have studied that Inflation targeting can be successful for counties, but there are many problems with the implementation of Inflation targeting. Some of the problems can be discussed as: -

## 7.1 Uncertainty

It won’t be an exaggeration to say that Fed and central banks have to operate under uncertain environments. Most of the times there is a considerable level of uncertainty in not just the size of the economy but also in the nature of the economy. Fed is never clear about the type of disturbances that can hit the economy. (Kenneth, 2005, pp 300) In fact this is the biggest problem that arises when economists try to forecast inflation. There are several indicators of the economy and these indicators present a different picture of the economy. Sometimes these indicators can also predict a contradicting picture of development in economy. With the uncertain environment central banks also find themselves in a difficult situation to decide upon the interest rates as banks have to forecast the interest rates to forecast inflation. The entire things are so mixed up that Inflation targeting cannot be thought of as an independent function. Inside monetary policy Inflation targeting and other functions are so linked up that even any uncertainty involved with any of the function can have an impact on other functions. Hence this associated uncertainty has to be taken care of as a whole.

## 7.2 Judgment

Many researchers and experts have denied the idea of Inflation Targeting just because it requires a judgment. A judgment has to be made by Fed and central banks regarding the future economic condition. The judgment is based on calculated assumptions and inferences however experts believe that judgment can turn in any direction. People who have criticized Inflation targeting have said that judgment should be made on solid quantitative methods and unless judgments are strong Inflation targeting can have negative effects also. The emphasis should be to reduce the risks associated with the economy of country. (Hendrik, 2006)

# 8.0 Future of Inflation targeting

The experts are divided over the future of Inflation Targeting. A possible and probable future issue is that should inflation targeting be transferred to flexible price level targeting. Today the economies of developed nations have turned global, they cannot just think of the economies of their domestic boundaries. Many countries have adopted inflation targeting. Even the countries, which do not have adopted inflation targeting, plan to do so in future. For countries, which do not target inflation still, have a rough framework and predictions of future. Based on the work of literature and the study it won’t be immature to predict that in future there would be more and more countries that would be explicitly targeting inflation. (Sheridan, 2003)

Both developed and developing nations would take this inflation targeting, as a phenomenon. In the coming future many countries would be in a position to target their inflation levels after studying the other countries. Inflation targeting is the word in the mouth of economists; experts all over the world are involved in more and more holistic work over the subject so that something concrete can be predicted about the future of Inflation targeting. One thing, for sure, that can be predicted is that there are very less chances that Inflation targeting would do more harm than good for any country. It seems that flexible inflation targeting would be the thing of future where Fed and central banks would not define the strict future levels of inflation but they would define the bands of inflation levels. The study in this regard is still two decade old and it would be still early to predict. The initial study and literature review has definitely given some positive signs about the future of inflation targeting. A lot would depend upon the Fed and congress that decide the wide level policies and strategies. In future it would be required that inflation targeting and other economic variables are defined in synchronization so that there impact on each other can be minimized.

The future looks a bit of insecure also as many economists believe that change in CPI (Consumer Price Index) is not always due to change in the internal economic atmosphere of the company. There have been situations in the past that inflation level has to be changed as per global economic scenario. This situation can occur in future also. Hence inflation should not be directly linked to other economic parameters of the country. The idea is that Fed should target both output levels and level of inflation.

Laurence Ball and other researchers have proposed an alternative to explicit Inflation targeting. They have suggested that there should be long term integrated plan to target the level of inflation. Fed should not worry about inflation in short term, their idea is that let market decide the short term inflation level, however Fed should have a long term vision to control and sustain the level of Inflation. This approached is also widely accepted in the market and many experts have backed up this approach. Having said that many experts believe that long-term sustainability can be achieved only by monitoring and controlling the inflation rate in short term.

# 9.0 Central Bank and Inflation Targeting

It has been observed that Interest rates and Inflation rates usually have an inverse relation and they move in opposite direction. Hence the move of central bank to raise or reduce the interest rates became more transparent with Inflation targeting. Two possible scenarios are: -

* Inflation in the country seems to be bit high; central bank would raise the interest raise in this situation. The advantage is that in such a scenario people would prefer savings rather than spending, hence there is a chance that Inflation can be brought under control.
* Inflation in the country appears to be below the target level, this signify that people are not spending much and they should be encourage to spend more. Central bank, in this scenario, would decrease the interest rates so that people get a push to spend more and save less. The expenditure of people would rise and consequently there would be a small increase in inflation level.

With this step the investors also know about the policies and future planning of bank. Investors know that what level of inflation is within the desired level of banks and what sort of inflation target banks has in mind. Many experts and economists believe that this should give a rise to increase stability in the economy and at the same time people would also have believe in Fed and government. Many advocates of explicit Inflation targeting has been of the view that a bit of Inflation is required for the healthy growth of the economy, hence its would always be better of Fed and central banks have target in their mind. (Hebbel, 2005) This approach should definitely help Fed in establishing the Inflation level of desirable 2% and at the same time the other functions of monetary policy can also be concentrated upon by Fed vis-à-vis Inflation targeting.

# 10.0 Conclusion

Many aspects of Inflation targeting were discussed in the essay. With our study one thing is pretty clear that Inflation targeting has potential to become an important part of monetary policy for most of the countries. In this era of globalization, economies of different countries have integrated under the similar scenarios. The economies of countries can not just function in isolation. It is imperative for economists of countries to devise the policies, which are flexible in nature and can be changed in this dynamic business environment. Hence economists prefer flexible inflation targeting rather than strict inflation targeting. The targets are indeed set up for each fiscal year however a bit deviation from these targets is accepted. Moreover these targets are soft in themselves that can be changed by Fed and central bank if there are some global economic events such as depression. By all means it can be said that US has strong case to adopt Inflation targeting. Thinking about the long term impact of the monetary policy and the decisions that would be made today one thing can be said that sooner the Inflation targeting is incorporated in the system better would be the result for economy. Having said that it should also be considered that there could also be negative consequences of the inflation targeting if economy of any country adopts a particular strict approach.

In this uncertain economic environment it is the dynamic nature and flexibility of economy counts. One of the important purposes of monetary policy is to reduce the associated trade off between output level and inflation level. Inflation targeting can play a crucial role in reducing this tradeoff. With inflation targeting the objective of Fed should be to make the entire system more efficient and democratic. People of the country should also get a chance to know a little about the policies of congress and Fed. The countries, which have adopted this framework, seems to be satisfied with the results, hence the countries, which have somewhat similar economic environment, can definitely think over inflation targeting. To adopt inflation targeting both economic and political motive is required. This is a major policy change, hence a strong political will and support of congress is required. This change may have its political implications also. Congress and Fed have to think of all these political considerations also. The fed future’s plan can not be predicted however it can be said that chances are there that US would go for at least flexible inflation targeting.

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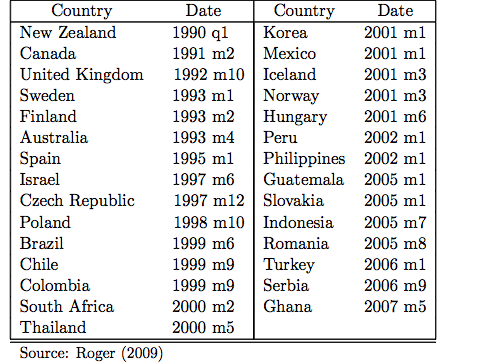
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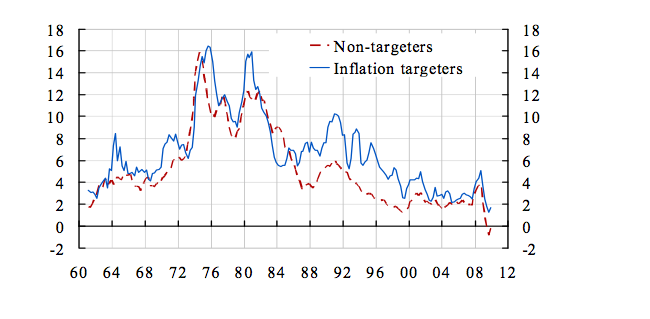
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# 12.0 Appendix

## Table 12.1 (Adoption Date of Inflation targeting)



## Figure 12.1 (Average level of Inflation in Inflation targeting and non-inflation targeting OECD countries)



**Source: EcoWin**