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Special Issue

Inflation targeting: Is there a credible alternative?

Editorial to the Special Issue

*Giuseppe Fontana**, *Mark (M.G.) Hayes*** and *Jonathan Perraton****

The contributions in this special issue on inflation targeting were presented at the Spring Seminar of the Post Keynesian Economics Study Group (PKSG) held at Balliol College, Oxford (UK) in April 2008. PKSG was founded in 1988 by Philip Arestis and Victoria Chick. The purpose of the Study Group (now formally a professional association) is to encourage collaboration among scholars and students of Post Keynesian economics, defined broadly as economics centred on the principle of effective demand. A detailed account of the history of PKSG can be found in Hayes (2008).

The Contributions tackle head-on a key issue faced today by policy makers and academics alike, namely the question of a credible alternative to conventional inflation targeting policies which have been pursued implicitly or explicitly by most, if not all, major central banks around the world during the last ten to fifteen years. For a long time, inflation targeting policies have been claimed to be a great policy success and to have delivered a low and stable inflation environment in the 1990s and early part of this decade. The Governor of the Bank of England coined the label NICE (Non-Inflationary Constant Expansion) for this period. In fact, during the first ten years of existence of the new policy regime and formal independence of the Bank of England, the UK Retail Price Index (RPI) inflation stood at an average of 2.7% (May 2007), compared to 4.5% of the previous decade, and 13% in the 1970s. Similarly, Alan Greenspan, the Chairman of the Federal Reserve of the United States from 1987 to 2006, was praised as the Maestro of the new policy regime and US economic success in the 1990s.

Others have been more critical, noting that there is no clear evidence that countries operating inflation targeting delivered superior performance and argued that the 'great moderation' of inflation since the 1980s owed much to luck in terms of a set of favourable circumstances that is now disappearing. The last few years have not been such happy years for

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defenders of inflation targeting policies. Most countries have been experiencing a high and very unstable inflation environment, which has been followed by the 2007 financial crisis and the severe recession of the last few months. Post Keynesians have always been critical of conventional inflation targeting policies. Over the past decade they have offered several counter-arguments and amendments to the conventional monetary policy strategies (see, for instance, Symposium 2002, 2006 and 2007). The Contributors in this symposium draw on this rich literature to explore in the face of the current financial crisis and recession an alternative to conventional inflation targeting policies.

The first paper, titled *The Post Keynesian alternative to inflation targeting*, is by Angel Asensio (University of Paris 13) and Mark Hayes (University of Cambridge). The purpose of this paper is to assess critically the methodological weaknesses of the New Consensus Macroeconomics (NCM) model and its inflation targeting policy implication. Asensio and Hayes contrast the enchanted ›optimizable‹ world of the NCM model to the ›non-ergodic/uncertain‹ world of Post Keynesian Economics (PKE), before considering the alternative policies proposed in the recent PKE literature. They argue that the control of interest rates is too imperfect for such policies to be feasible in general, although they provide useful guidelines and may be successful in favourable circumstances. Consequently, Asensio and Hayes maintain that the question of credibility is irrelevant, if this means whether policy-makers will honour their commitment to an unfeasible ideal inflation target. The right question is whether policy is convincing enough to make the conventional state of expectation (and the related interest rate) consistent with full employment. It is all a matter of confidence. The basic principles involved in such an approach to monetary policy are discussed.

The second paper, titled *Interest rates and inflation: What are the links?*, by Malcolm Sawyer (University of Leeds) examines the transmission mechanism of inflation targeting policies. Sawyer argues that there is a tendency to slip from arguments in which the rate of interest is related to the price level to suggesting that the rate of interest is related to the rate of inflation. Conventional inflation targeting policies are examined and found to support more the view that the rate of interest impacts the level of prices rather than the rate of inflation. It is also argued that the route through the exchange rate does not support the view that higher interest rates will dampen down inflation (though it may lower prices relative to what they would have been). It is further argued that the link from the level of economic activity to the rate of inflation is theoretically dubious. Finally, Sawyer also maintains that there is a lack of empirical support for any strong link from interest rate to inflation.

The third and final paper of the symposium, *The General Theory and monetary policy: Investment versus inflation*, by Geoff Tily (Government Economic Service, UK), discusses Keynes's theory of investment and of the economic cycle. Tily argues that conventional inflation targeting policies are not credible within the context of Keynes's theory. Rather, given their implicit endorsement of financial liberalisation, conventional inflation targeting policies are, and have proved to be, deeply dangerous. Keynes advocated policies aimed at setting a low long-term rate of interest. Financial liberalisation has led to an ›easy credit, dear money‹ regime that Keynes understood as the cause of the Great Depression. Tily also examines Keynes's vigilant approach to inflation and argues that the inflation of the

1970s was also connected with liberalisation, and not with Keynes. He laments the loss of the central role for investment and the pre-occupation with inflation in recent PKE literature and defends a return to Keynes's theory of investment through an historical analysis of events from the golden age to the present debt-deflation. Together these papers provide a critical commentary on a policy regime that is only now being questioned in mainstream circles with the onset of the current financial crisis.

Since April 2008, PKSG has continued its activities with a seminar at Stirling, Scotland, in September 2008 and a complete series of sixteen seminars, the ›Keynes Seminar‹, at Robinson College, Cambridge (UK), from October 2008 until March 2009. The Keynes Seminar talks and presentations can be downloaded from the PKSG website, www.postkeynesian.net. PKSG has also organised a continuous series of panel sessions on topics of particular interest to Post Keynesian economists at the annual conference of the Association for Heterodox Economics (AHE), 9 – 12 July 2009, Kingston University, London. Topics include macroeconomic policy, international economics, banking and corporate finance reform, history of economic thought, the ›Green New Deal‹ and ›Marx, Keynes and the crisis‹. Further details can be found on the website.

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