

## ■ Conversation With Laurence Ball

The issues covered in this conversation were discussed personally with Professor Ball during his visit to Brazil in the middle of May 2013. He delivered the keynote address at the XV Annual Seminar on Inflation Targeting, sponsored by the Central Bank of Brazil, and paid a two-day visit to the Instituto Brasileiro de Economia (FGV/IBRE), where he made a presentation on the US monetary Policy. The formal conversation was held through an exchange of emails between J.J.Senna and Laurence Ball in the first days of June 2013. Professor Ball teaches at The Johns Hopkins University. He is also a research associate of the National Bureau of Economic Research and a visiting scholar at the International Monetary Fund.

■ You have just given the keynote speech of XV Annual Seminar on Inflation Targeting, sponsored by the Central Bank of Brazil. In your address you suggested that monetary policy makers should have an explicit employment objective. It is generally understood, however, that central banks which follow the inflation targeting regime already take into account the estimated output and employment gaps. The example you gave – the ECB – seems to be an exception, derived from the fact that the rules of the game were imposed by the Germans as a precondition for giving up the deutsche mark. Perhaps the Bank of England would be a more typical example of an inflation-targeting practitioner. In this case, if the economy has been hit by adverse shocks, the central bank avoids forcing the immediate convergence of inflation to target. Frederic Mishkin has called this sort of behavior the “dirty little secret” of central banking. My question is: doesn’t this already give a substantial degree of flexibility to the system? Do we really need an explicit employment objective, as proposed by you at that seminar?

The proposition that it’s OK to target inflation without an explicit employment objective depends on the assumption that unemployment always returns to a fixed natural rate. Under that assumption, the worst that the absence of an employment objective can do is magnify short run fluctuations in unemployment. In my view, insufficient attention to employment can have much more harmful effects: because of

hysteresis, unemployment may rise permanently, or at least for a very long time, unless policymakers have a clear goal of keeping it low.

The ECB may be an extreme case, but other countries with inflation targets have seen the natural rate of unemployment drift up—in Sweden, for example, the financial crisis and recession of the 1990s seems to have had a permanent effect on unemployment. If Swedish policymakers had a clear employment mandate, they might have followed more expansionary policies and prevented some of the long-term rise in unemployment.

Even if a central bank has an implicit employment objective, this objective is likely to receive less weight than an explicit inflation target. Central bankers are judged more harshly for failing to achieve an explicit target than for failing to achieve an implicit target, because the failure is more clear-cut. The laws governing central banks should make it clear that policymakers will be held accountable for what happens to employment as well as inflation, so that policymakers have an incentive for balanced policies rather than policies that over-emphasize inflation.

■ **In your defense of an explicit employment objective you seem to have in mind a regime similar to the one practiced in the US, that is, a dual mandate. This type of strategy has not been widely tried. When you propose the dual mandate, do you think of its adoption on a temporary basis, that is, something to last until all the signs of the current crisis disappear, or what you have in mind is something more permanent? Don't you think that such a model is applicable only to countries where the monetary authorities have already acquired a high degree of credibility? What about economies like Brazil, with a long history and memory of inflation?**

Before the 1990s, many central banks said they sought full employment, or some similar goal, as well as price stability. The idea of a single mandate was introduced by Canada and New Zealand, the IT pioneers, in the early 90s. And, in my reading of the

historical record, this shift has not been an improvement. It has contributed to long-term increases in unemployment in many countries.

I believe that central banks should restore employment mandates and do so permanently. The problems with a single mandate are not specific to the post-2008 crisis. Even before then, many European countries had persistently high unemployment—often near ten percent—as a consequence of their overemphasis on inflation. Unemployment was relatively low in the U.S. before 2008, and I attribute that largely to the dual mandate.

Certainly it is important for Brazil to avoid a return to extremely high inflation rates. But I do not believe that goal requires a single-minded focus on inflation. The fact that inflation is running near the top of the BCB's target range does not suggest to me that inflation will explode as it did in the 1980s. Again, it is possible for policymakers to be balanced—to put substantial weight on unemployment without being over-expansionary and letting inflation get out of control.

■ In an article dated March 2009 (“Hysteresis in Unemployment: Old and New Evidence”, NBER WP 14818), you gave a specific reason for the suggestion that central banks should not focus too heavily on inflation. The reason is that there is evidence of the existence of hysteresis in unemployment, that is, a given tightening of monetary policy lowers aggregate demand and raises observed unemployment, which, in its turn, through mechanisms still not completely understood, provokes an increase in the natural rate of unemployment. Your analysis of the experience of the 1980s allowed you to conclude that “there is a significant relationship across countries between the size of the inflation decrease and the change in the NAIRU”. And that the change in the NAIRU seemed to be related to the length of time over which disinflation occurred as well. In other words, to reduce high inflation rates costs more than we normally imagine because of lasting impacts on unemployment. Couldn't I then argue in the

**opposite direction, that is, that central banks should focus heavily on inflation, doing all their best to maintain it low and stable?**

It is a fair point that hysteresis makes it costly to reduce inflation, which increases the importance of preventing inflation from rising to a level where disinflation is necessary. However, I believe that many central banks have pursued policies that are more contractionary than necessary to keep inflation low and stable. In the U.S., the Federal Reserve has responded to increases in unemployment by cutting interest rates, and that has pushed unemployment down—and that has happened without inflation taking off. Other central banks—such as the ECB and the central banks of European countries before the euro was introduced—have kept policy tight in the face of rising unemployment. Their inflation outcomes have not been much better than those of the U.S., and their unemployment outcomes have been worse. I’m repeating myself, but I think the key idea is that a policy framework that has a balanced emphasis on both inflation and employment can achieve good outcomes for both variables.

■ **The idea of a 4.0% inflation target was also raised in your presentation at the Central Bank seminar. The motivation would be to lower the probability of reaching the interest-rate zero bound. In a just published paper, “The Case for Four Percent” (Central Bank Review, Central Bank of the Republic of Turkey), you mentioned that one of the objections to this proposal has to do with the impact of high inflation rates on economic growth. You then added that existing empirical works suggest that in order for inflation to hurt growth, it has to be above a given threshold. And that the estimates of this threshold vary considerably, going from 8.0% to 40.0%. Wouldn’t the disparities observed in these estimates be a sign that we still do not know much about this issue? This being the case, shouldn’t we then be more conservative in choosing the target for inflation?**

I would say that a range of estimates from 8% to 40% suggests that 4% is safe—it is only half of the lower bound of the range. In any case, the estimates that you mention, based on cross-country comparisons of inflation and growth, are only one piece of evidence on the costs of inflation. There are also studies that try to measure the

specific costs of inflation described in textbooks, such as Stan Fischer’s work in the 1980s on relative price variability, and work that seeks to measure the effects of inflation uncertainty on investment. As Paul Krugman has written, the measured costs of inflation from such research are “embarrassingly small.”

My intuition about inflation is influenced strongly by the U.S. experience of the 1970s and 80s. The double-digit inflation of the 70s was considered unacceptable by both policymakers and the public, and they applauded Fed Chairman Paul Volcker when he “conquered” inflation in the early 80s. People forget that this conquest meant that inflation was reduced to about 4% in the second half of the 80s. At the time, few people worried that inflation was still too high, and looking back I can’t see any significant ways that 4% inflation undermined the efficiency of the economy. The idea that only 2% inflation is acceptable—like the idea of a single mandate—started to become popular only in the 1990s, and I do not think it is supported by history.