IMF seeks 4% inflation

IMF believes the best way to get out of the current economic recession and avoid deep recessions in the future Central Banks should target inflation at 4%. Some Central Banks and Policy Makers think its outrageous and irresponsible.

In a paper titled 'Rethinking Macroeconomic Policy' Three IMF economists out line their views.
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Stable and low inflation was presented as the primary, if not exclusive, mandate of central banks. This was the result of a coincidence between the reputational need of central bankers to focus on inflation rather than activity (and their desire, at the start of the period, to decrease inflation from the high levels of the 1970s) and the intellectual support for inflation targeting provided by the New Keynesian model.

In the benchmark version of that model, constant inflation is indeed the optimal policy, delivering a zero output gap (defined as the distance from the level of output that would prevail in the absence of nominal rigidities), which turns out to be the best possible outcome for activity given the imperfections present in the economy.

When the crisis started in earnest in 2008, and aggregate demand collapsed, most central banks quickly decreased their policy rate to close to zero. Had they been able to, they would have decreased the rate further: estimates, based on a simple Taylor rule, suggest another 3 to 5 percent for the United States.

But the zero nominal interest rate bound prevented them from doing so. One main implication was the need for more reliance on fiscal policy and for larger deficits than would have been the case absent the binding zero interest rate constraint.

It appears today that the world will likely avoid major deflation and thus avoid the deadly interaction of larger and larger deflation, higher and higher real interest rates, and a larger and larger output gap. But it is clear that the zero nominal interest rate bound has proven costly. Higher average inflation, and thus higher nominal interest rates to start with, would have made it possible to cut interest rates more, thereby probably reducing the drop in output and the deterioration of fiscal positions.

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