Raising an inflation target: The Japanese experience with Abenomics

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Outline

- Summary
- Comments
- Directions for future research

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  - Identify inflation target shocks using long-run restrictions
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  - Reflating economy requires large inflation target shock

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- Studies (real) effects of raising inflation target
- Focuses on Japan's experience and Abenomics (2013)
- VAR analysis:
  - Identify inflation target shocks using long-run restrictions
  - Temporary positive output response, more pronounced at ZLB
  - Reflating economy requires large inflation target shock
- DSGE analysis:
  - Supports results from VAR analysis
  - Reveals importance of credibility (or 'observability') of raising target
  - Inflation and output responses muted under imperfect credibility

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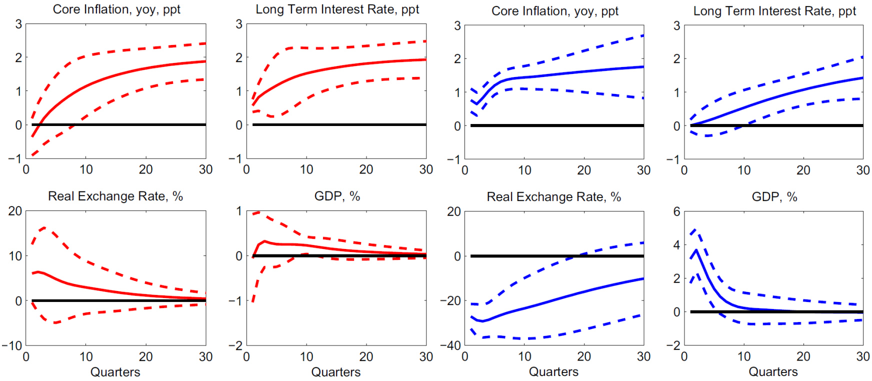
The real exchange rate channel

Inflation target shocks: VAR evidence for Japan

Left: 1974Q1-1993Q4, right :1994Q1-2015Q2



De Michelis and Iacoviello (2016), p. 7

The real exchange rate channel (cont.)

- RER pass-through seems important channel for output response
  - Higher inflation reduces real rate...
  - ...causing depreciation of real exchange rate...
  - ...which fuels inflation more through higher import inflation

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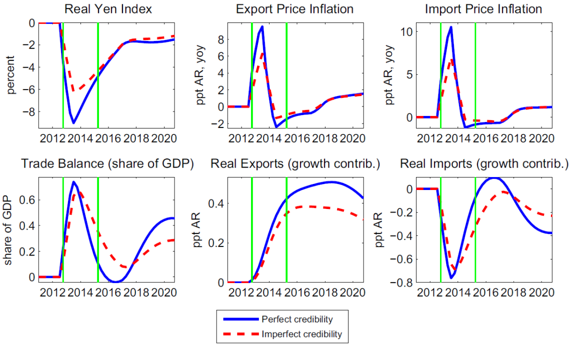
- RER pass-through seems important channel for output response
  - Higher inflation reduces real rate...
  - ...causing depreciation of real exchange rate...
  - ...which fuels inflation more through higher import inflation
- DSGE analysis doesn't deliver 'sufficient' RER depreciation
- Therefore, authors add additional 'exchange rate shock' modelled as an exogenous rise in the risk premium on domestic bonds

The real exchange rate channel (cont.)

Inflation target and exchange rate shock in SIGMA



De Michelis and Iacoviello (2016), p. 17

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- Perhaps RER depreciation during low inflation period reflects QE
- Additional ‘QE shock’ more appropriate in this context
- Augment model with explicit financial sector and allow for QE shocks
  - Capture RER depreciation following implementation of Abenomics
  - Investigate benefits of combining QE with raising inflation target
    (e.g. might make inflation target hike more credible)

Higher inflation target and inflation expectations

"...raising the inflation objective would likely entail much greater costs than benefits. Inflation would be higher and probably more volatile under such a policy, undermining confidence [...]. Inflation expectations would also likely become significantly less stable."

Ben Bernanke, Jackson Hole Symposium, 2010.

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  - Requires adaptive learning environment (rather than RE)
  - Allow for self-fulfilling expectations and un-anchored inflation expectations

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- Ascari et al. (2015): a higher inflation target...
  - ...weakens link between output and inflation in NK Phillips curve
  - ...shrinks E-stability region for given Taylor rule
  - ...slows down speed of convergence of expectations to REE
  - ...raises inflation and output volatility

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- Implications of higher inflation target for (optimal) monetary strategy?
- Higher inflation target raises price dispersion (Ascari and Sbordone, 2014)
  - Affects long-run output and welfare
  - Has implications for long-run identification scheme in VAR analysis

Other avenues

- Interactions with fiscal (and other supporting) policies:
  - How to successfully achieve a higher inflation target?
- Application to monetary union:
  - How to deal with heterogeneous inflation dynamics/expectations?
- Role of anticipation effects?
- Which inflation target is optimal?