The optimal rate of inflation

The literature contains numerous arguments about the optimal rate of inflation. The readings challenge the simple view that inflation merely distorts market signals and that price stability is therefore optimal. There is a certain amount of argument about the quantification of particular effects, but in the main different authors have introduced different considerations. The task, which has real policy implications, then, is sifting through the various sorts of argument to determine which are of salience in determining an inflation goal.

Reading

There is an overview of a number, though not all, of the relevant issues in Schmitt-Grohé and Uribe (2010). Considering issues separately, one finds arguments based on not much more than common sense, that any stable rate of inflation is about as good as any other – Friedman (1968) makes one, although it needs to be read without preconceptions that it is all about the Phillips curve. That view might be rejected or modified by the idea that inflation 'lubricates' the labour market: Akerlof, Dickens and Perry (1996), but also a challenge as to how the lubrication effects should be compared to the 'sand in the wheels' inflation causes: Groshen and Schweitzer (1999). It is sometimes said that questions of public finance make a case for inflation. That argument can be found, for example, in Phelps (1973). Later authors have added the thought that inflation particularly taxes cash-based activities, of which criminal ones may well be a large part. There is, though, a clever, little noticed, challenge or modification to the Phelps-type view in Friedman (1971).

Other specific issues in optimization of firm behaviour have been raised by Sinclair (2003) and Other sorts of specific reasons for favouring limited inflation have been suggested. Ideas on the general lines that some aspect of economic activity is improved by some inflation can be found in Tobin (1965) and Fischer (1974). Looking at the same matter from a different angle, one might consider the statistical relationship between inflation and growth, on which there was much attention in the 1960s and 1970s, but Sarel (1996) offers a later analysis. A more esoteric thought arises from Barro and Gordon (1983) in the context of designing credible policy commitments. And the question of optimizing policy in the light of the risks raised by the zero lower bound have recently been thought to make a case for higher rates of inflation by Ball (2014), although you might like to consider Ascari and Sobordone (2014) as well, the first author being at Oxford. On the other hand, it has been argued that falling prices generate benefits in increasing liquidity: Friedman (1969).

Finally, and on a slightly different tack, it should perhaps be noted that there is a question about the measurement of inflation and the welfare effects of different rates of measured inflation: Moulton (1996), Boskin, Dulberger et al. (1998). Those considerations might for example affect the chosen target rate of measured inflation once the principles of what is optimal are resolved. There are, though, contrary arguments, such as in Gilbert (1961).

What target rate of inflation should central banks be told to achieve? Which are the decisive considerations in reaching your conclusion?

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