Raising the Inflation Target: How Much Extra Room Does It Really Give?
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Motivation: Lack of room for monetary policy

- Our question:
  If raise the target to get extra room: What are the constraints faced by the policy maker?
- Not only theory: we quantify these constraints
- How much more policy room does one really get?
  - Some, but less than intended
  - Reason: Private sector will react to policy
  Thus: target needs to be raised by more

First-Order Reaction by Private Sector

- Firms adjust prices more frequently
  - Old idea: Ball, Mankiw & Romer (1988) higher trend inflation \( \rightarrow \) increased price flexibility
  - We present new empirical evidence
- Phillips Curve steepens + Potency of monetary policy ↓
- Key implication:
  Need to adjust nominal rate by more in recessions

Results

1. Evidence on relation between target and frequency, U.S.
2. Because of potency loss: effective extra room < intended extra room
   Raising from 2 to 4%: only 0.51 to 1.60 pp. eff. extra room To effectively get more room, need to increase target by more
3. Higher optimal target

Intended and Effective Extra Room

Effective extra room is substantially smaller than intended room