Central Bank Independence and Inflation Targeting in the Aftermath of Crises

At SARB Conference:

25 years of Inflation Targeting

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Donald Kohn

Senior Fellow

Brookings

Inflation targeting and independence

- IT strengthens operational independence
  - IT establishes clear demarcation between democratically set goal and technocratic decisions on operations to achieve that goal
  - Focus for transparency and accountability
- Crises stress test both IT and independence
  - Goals may take time to achieve after a large negative shock. (GFC)
  - Employment or growth goal may threaten to be in conflict with price stability (Covid)
  - Unconventional policies may be necessary, but are poorly understood by the public, politicians, and some academics. (Both)
  - Crises accentuate partisan divides and reduce confidence in technical expertise. (Both)

IT and Independence: the GFC

- Inflation targeting in the US—a brief history
  - Implicit IT in the great moderation: 1982-2007
    - Price stability=inflation low enough HH and businesses can ignore
    - Price stability is the path to maximum employment
  - IT becomes explicit in the GFC
    - 2009 long-term projections; 2012 explicit target
    - Facilitates aggressive easing with unconventional policies.
  - IT drives 2020 framework changes
    - Persistent shortfalls from target post GFC
    - Disinflationary asymmetry of ELB in low rate, low inflation world

IT and Independence: the GFC

- Threats to independence post GFC: the challenge of unconventional policies
  - Pushback on QE
    - Unconventional policies were poorly understood—inflation fears
    - QE encouraged irresponsible fiscal policy; compromised independence
    - Played into political polarization: letter from Congressional leadership
  - Pushback on zero rates
    - Proposals for legislating more rules-based policy
- Trump 1.0
  - Conventional political pressures
  - But probing legal limits on independence

IT and Independence: Covid

- The challenge of the inflation overshoot
  - Complex and unprecedented mixture of supply and demand factors
    - "Looking through" supply shocks; team transitory
    - But forecast misses
    - Prior strategy adaptation to low inflation raised questions about relative weights on maximum employment and stable prices
  - Inflation target as lodestar and disciplining device
    - And people really dislike inflation
  - Inflation outcome reduced confidence in the central bank
- Heightened importance of operational independence in complex circumstances, like supply shocks, in which short-run trade offs may be required to achieve long-run goals

IT and independence going forward: lessons learned

- Difficult monetary policy environment--likely to face:
  - Adverse supply shocks from tariffs, reduced globalization, demographic pressures on labor forces, (geopolitical volatility; climate change?)
    - And therefore short-term trade offs, judgements about first and second round effects, when to look through
  - Upward pressures on interest rates from persistent elevated budget deficits
  - Heightened uncertainty from shifting and contradictory government policies
  - Persistent political biases toward lower interest rates

IT and independence going forward: lessons learned

- Lessons from the GFC and Covid
  - Importance of **price stability** commitment embodied in an inflation target
  - Critical role of **operational independence** in achieving price stability over time
  - Explain, explain, explain
    - Role and rationale of unconventional policies when required
    - Story telling; linking short-term developments to long-term objectives
    - But context of uncertainty and range of outcomes
    - Reaction functions
      - Alternative scenarios
    - Communicate with the general public as well as markets, legislators, and academics