MONETARY POLICY MONITOR

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Year 1 | Number 1 | March 2013

▪ Issues and Episodes in Monetary Policy

KEYNES AS THE "FATHER" OF INFLATION TARGETING

In his early writings, the British economist John Keynes revealed a very critical view of the gold standard. Under the rules that prevailed prior to World War I, a country which experienced an inflow of international reserves should inflate the economy, that is, should allow the money supply to increase. Rigorously speaking, it should not only allow but stimulate monetary expansion, acting in such a way as to reinforce the original movement. Full adherence to the "rules" would mean that the balance sheet of the monetary authorities would show an increase both in the volume of international assets and in the volume of domestic securities, acquired by the authorities. In principle, this would make prices to go up, domestically. In consequence, the country would lose competitiveness. The opposite would occur elsewhere, as a result of a shrinking money supply in the rest of the world. After some time, and assuming no further shocks, equilibrium would tend to be reestablished.

Keynes based his criticism on two aspects of the problem. First, in his words, "this process might take months to work itself out." Considering the case of a country facing an outflow of reserves, "the gold reserves might be dangerously depleted before the compensating forces had time to operate." (Keynes 2000, p. 160). Second, "the movement of the rate of interest up or down sometimes had more effect in attracting foreign capital or encouraging investment abroad than in influencing home prices." (Keynes 2000, p. 160). If the disequilibrium was purely seasonal, so the argument proceeded, this would work as an "unqualified advantage", but if it was due to more permanent causes, the adjustment would be "imperfect".

With the outbreak of the World War I, the countries which had adhered to the international gold standard were forced to leave the system. When the war came to an end, it was only natural to consider returning to the old regime. After all, the decades immediately before the war were periods of considerable economic prosperity. The US went back to that regime as early as 1919. In England, there was a fierce debate.

Loyal to his own early thoughts and writings, Keynes placed himself against such a return, adding that the gold standard was already a “barbarous relic”. (Keynes 2000, p. 172).

The decision to go back to gold was taken by Winston Churchill, then Chancellor of the Exchequer. Keynes was particularly concerned with the fact that from 1913 until mid-1923, in England, wholesale prices had gone up by around 60.0%, and nominal wages had probably risen by a similar percentage. “If Mr. Churchill had restored gold by fixing the parity lower than the pre-war figure”, at least part of the criticism would disappear. But by restoring the old parity, Churchill was “committing himself to force down money wages and all money values, without any idea how it was to be done. Why did he do such a silly thing?”, asked the economist. (Keynes 1963, p. 248).

Keynes attributed the disastrous performance of the British economy in the years which followed the return to gold, marked by extraordinarily high levels of unemployment, to the decision taken by Churchill in 1925. When that system was abandoned, in 1931, this was Keynes’ reaction, expressed a few days after the event: “There are few Englishmen who do not rejoice at the breaking of our golden fetters. We feel that we have at last a free hand to do what is sensible”. (Keynes 1963, p. 288).

As we see, Keynes had no sympathy at all for the gold standard. But he equally disliked what happened in several countries as a result of World War I. To finance their war efforts, the governments of the countries directly involved in the conflict resorted to money creation, of a fiat nature, in an unprecedented scale. Inflation accelerated, quite rapidly. In some countries, this process was somehow reversed, in a matter of a few years; in others, not. In any case, in England, about half of the real value of financial assets was consumed by inflation. In France and Italy, approximately 90% of the financial savings were eroded by the same phenomenon, while in Germany the stock of financial assets was totally wiped out.

Keynes stressed the fact that all those countries “experienced an expansion in the supply of money to spend relatively to the supply of things to purchase, that is to say inflation”. From 1920 onward, some countries regained control of their financial situation and, “not content with bringing the inflation to an end, have contracted their supply of money and have experienced the fruits of deflation." Both phenomena ("inflation and deflation alike") had "inflicted great injuries." (Keynes 2000, pp. 3-4). Based on this reasoning, Keynes started to defend a "deliberate State policy" geared to the promotion of the stability of the value of money. Only this would stimulate and preserve voluntary savings, allowing its channeling into productive investments. (Keynes 2000, p. 17).

Keynes suggested that the Treasury and the Bank of England "should adopt the stability of sterling prices as their primary objective", abandoning the policy of stabilizing the exchange rate. In pursuing this objective, the actions of the policy makers should have a preventive character, with attention concentrated on the future behavior of prices. In Keynes' words, "it would not be advisable to postpone action until it was called for by an actual movement of prices". (Keynes 2000, p. 187). To promote confidence, an official index number should be compiled, and the authorities should "adopt this composite commodity as their standard of value in the sense that they employ all their resources to prevent a movement of its price by more than a certain percentage in either direction from the normal". Please notice that, in this note, we do not make a distinction between stability of the price level and stability of the rate of inflation, at low levels.

Keynes argued that more research was necessary for one to "understand the right time and method for controlling credit-expansion by bank-rate or otherwise". As to what should guide the authorities' actions, he had the following suggestion: "actual price movements must of course provide the most important datum; but the state of employment, the volume of production, the effective demand for credit as felt by the banks, the rate of interest on investments of various types, the volume of new issues, the flow of cash into circulation, the statistics of foreign trade and the level of the exchanges must all be taken into account. The main point is that the objective of the authorities, pursued with such means as are at their command, should be the stability of prices". (Keynes 2000, pp. 188-89).

At the time of the writings quoted in this article, Keynes was convinced that the adoption of fiduciary money was simply "inevitable". (Keynes 2000, p. 204). Please notice that his defense of such a system was made in the early 1920s, that is to say, more than 20 years prior to its universal adoption, apparently on a permanent basis. In his understanding, the currency should be “managed”.

In conclusion, let us now compare the reasoning formulated by Keynes with what Ben Bernanke and three co-authors said about the modern inflation targeting regime. Right in the beginning of their book, the authors explained why it would be wrong to think of the mentioned regime as a policy rule. The explanation was partly this: “[…], at a technical level, inflation targeting does not provide simple, mechanical operating instructions to the central bank. Rather, inflation targeting requires the central bank to use structural and judgmental models of the economy, in conjunction with whatever information it deems relevant, to pursue its price-stability objective. In other words, inflation targeting is very much a ‘look-at-everything’ strategy, albeit one with a focused goal”. (Bernanke et al., 1999, p. 22).

The policy recommendation that emerged from Keynes’ reasoning – look at everything but have your attention concentrated on the future behavior of prices -, so much time in advance of present-day discussions, allows us to think of the British economist as the father of the inflation targeting regime.

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