

## Motivation: Lack of room for monetary policy

### Raising the Inflation Target: How Much Extra Room Does It Really Give?

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#### ► 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*

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## 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  $\downarrow$
- Key implication:  
**Need to adjust nominal rate by more in recessions**

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## Results

#### 1. Evidence on relation between target and frequency, U.S.

#### 2. Because of potency loss:

$$\text{effective extra room} < \text{intended extra room}$$

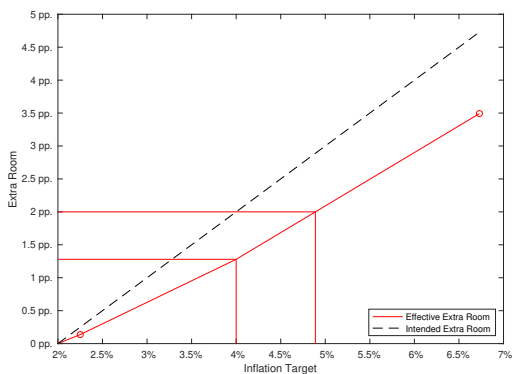
Raising from 2 to 4%: **only 0.51 to 1.60 pp. eff. extra room**  
To effectively get more room, need to increase target by more

#### 3. Higher optimal target

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## Intended and Effective Extra Room



Effective extra room is substantially smaller than intended room

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