Pre-conference draft

Comments on McKibbin and Panton ‘25 Years of Inflation Targeting in Australia: Are There Better Alternatives for the next 25 Years’

If the task is to see what alternatives there are to the current Flexible Inflation Targeting (FIT) regime, the starting point is to examine what’s gone wrong. In Australia and elsewhere, FIT has served us well in delivering pretty consistent low inflation in the 1990s and in the first half of the 2000s -- Mervyn King’s NICE, a.k.a. ‘the Great Moderation’. FIT shouldn’t take much of the blame for the GFC as this was mainly a failure of prudential supervision in the crisis countries. The only charge that could be made against FIT is that it might have made central banks too complacent and a bit blinkered so that they overlooked finance. But FIT did its job as advertised: it delivered price stability.

The period after 2008, however, revealed some deeper concerns. If we are now asking what alternatives there are to FIT, then the focus should be on how such alternatives might better address these newly recognised inadequacies, while at the same time retaining the well-proven advantages of FIT.

Two problems can be identified – the first more easily addressed than the second.

- The first is that the simple and unambiguous **policy guidance** that FIT provided doesn’t seem simple any longer. We used to think that if we focused just on inflation (or, more precisely, the forecast of inflation), that would be enough to tell us when to raise or lower interest rates. The 2007/08 experience in the US and European has shown that inflation didn’t fall as much as might be expected, given the rise in unemployment. Recent experience in the USA has demonstrated that some version of ‘fully employment’ could be attained (or perhaps even exceeded) without this showing up clearly in wages or inflation. FIT policy guidance depended on the ‘divine coincidence’ of full capacity and inflation and on a fairly clearly defined Phillips curve, and neither seems reliable[1].

[1] The lower trend trajectory also suggests hysteresis and a disconnect between output and inflation. See Blanchard, Cerutti and Summers (2015)

- The second (more serious) problem is that **interest rates didn't work as well as we had hoped** in addressing the macro-problems of the past decade. There are two aspects of this 'not working well' problem. Even with policy interest rates at historically low levels for a substantial period, the universal experience has been that this didn't seem to have much effect in stimulating output. Economies usually experience fast recoveries after deep recessions, but the post-2008 recovery was pathetically slow just about everywhere. Pushing harder on the instrument (lower interest rates) ran into the effective lower bound (ELB). The text-book problem of the Zero Lower Bound became a problem in practice. The second aspect of this 'not working well' problem was that the low policy rates DID seem to have quite an impact on financial markets – not a central part of the FIT mind-set[2]. Lower interest rates stimulated asset prices, which must have helped output to some degree, but at a cost. This cost is just one manifestation of a broader concern. Monetary policy works by distorting[3] short-term interest rates -- one of the key prices in financial markets. Specifically, stimulatory policy works by putting the policy interest rate below the neutral (Wicksellian) interest rate, which distorts financial decisions, expectations, budgets, balance sheets and incentives to invest and to save. Asset prices have been the most obvious manifestation, but not the only one. Borrowing is cheaper, so there is a lending boom which entices households into borrowings which may well prove excessive when normality returns. A bubble in asset prices combined with excessive lending may even put financial stability at risk. Zombie companies stay alive with below-normal interest rates. Exchange rates are distorted, leading to accusations of beggar-thy-neighbour. Balance sheets of pension and insurance funds are at risk, with asset duration no longer matching long-term liabilities. Self-funded pensioners find their retirement plans altered. In normal circumstances, these distortions are acceptable, even desirable: they are, after all, the channels through which monetary policy operates. But if the policy interest rate is set below the neutral rate *by a large margin and for an extended period of time*, these distortions provide a less-acceptable trade-off. Policy-makers are in an uncomfortable bind. Their instrument hasn't delivered the expected (and desired) impact on the main

[2] See Borio et al (2018).
[3] For two different views on 'distortions', see Bernanke (2017) and Blanchard (2017 (a))

objective of encouraging activity (and getting inflation back to target), but has had these on-going detrimental effects on the financial sector and elsewhere. The result is a policy tension. Central banks just about everywhere feel the urge to get their policy rates back to 'normality' as quickly as possible. But their FIT target constrains them (even delivers the oppose policy guidance), and the combination of asset booms and over-leveraged borrowers threatens an uncomfortable period when interest rates return to 'normality'.

Having identified these problems, we can now turn to the various suggestions for either alternatives to FIT or additions. Let's not spend any time on money targets or exchange rate targets. No country is going there, although some developing countries will want to keep one eye on exchange rates because of the volatility of foreign capital flows.

What about the favoured alternative in the paper under discussion – targeting nominal income growth instead of inflation. If any central bank was using a pure version of inflation targeting rigorously focused just on inflation, the case for this alternative is easier to understand – this is the context in which a GDP target shows itself to be superior, especially in responding to supply shocks. But for a FIT regime which has some ability to take account of output, the question is whether combining both inflation and output together in a single target is superior to being able to look at them separately (it's worth noting that the usual Taylor-rule doesn't have the same coefficients on output and inflation). It is also worth noting that nominal income growth is much more variable than inflation, especially in Australia where export price volatility is important. The variance may well be unbiased, as the paper shows, but when the central bank has to explain its policy changes, big variations in the recent figures will be inconvenient, to say the least. And there are the old problems of delays and revisions to data. In short, it seems doubtful that the alternative of GDP targeting would have done any better than FIT either during the GFC or in the recovery period. At the same time, it would have diminished the focus on inflation, thus weakening the expectations-anchoring function.

The post-GFC decade has seen innovations (some proposed, some implemented) to modify and supplement FIT overseas (but not Australia): quantitative easing; forward guidance; price-level targeting; helicopter money; and measures to address the effective lower bound (higher target, negative interest rates) [4]. In addition there are options that address financial sector stability issues more directly: the 'lean-or-clean' debate; and the new panacea of macro-prudential policy.

This isn't the place to evaluate QE at length[5]. It might be enough just to note that there is a growing consensus that its effect is specific to time and circumstance. It was clearly very effective in getting frozen mortgage markets working again in 2008, but it looks like QE3 didn't have much effect. Its use as a signaling device can be done more directly by other more precise signaling methods. And as for its portfolio effects, analysis seem to neglect the portfolio effect on the banking sector being forced to hold substantial excess reserves. I'm a sceptic on QE's reliability as a policy instrument. It's also worth noting that long-term interest rates play a smaller role in countries like Australia, where floating rates are the norm for much borrowing.

I find the usual discussion of forward guidance unhelpful. The FIT system already embodies a very clear and explicit description of how the policy-makers will react to unfolding circumstances. If financial markets have a very different view of how output and inflation are likely to develop over time, there might be some point in the central bank striving to make its own forecasts of these two variables more convincing (this might be what 'Delphic' means, where there is no commitment e.g. the US 'dot-plot' forecasts or the RBNZ policy forecast)[6]. But if the central bank goes further ('Odyssean') and essentially over-rides the policy response built into the FIT process (by, for example, setting a specific unemployment target or a commitment not to change the policy rate for a specific period), then this undermines the beautiful simplicity of the FIT framework[7].

I put Bernanke's idea of setting a temporary price-level target when the central bank wants to signal a long period of low policy rates in much the same category --

[4] For good discussions on these possibilities, see Bernanke (2017), Blanchard and Summers (2017), and Cicchetti (2017)

[5] See Cicchetti (2018)

[6] See Tarullo (2017) for insights into how Fed Board members view these forecasts.

[7] Both the Bank of England and the Swedish Rijksbank got themselves into trouble with Odyssean promises that they over-rode later.

as a substantial over-ride on the well-understood FIT framework. Desperate times might justify desperate responses, but are we that desperate?

We can dismiss helicopter money quickly. It is fiscal policy (funded from the central bank balance sheet), not monetary policy, and should have the same governance procedures which surround fiscal policy. It is not something that the central bank should decide to do on its own initiative. More fiscal expansion (or at least less contractions) certainly would have been a good idea during the feeble recovery in 2011-13, but this was not (and is not) part of the central bank's remit.

Trying to get more room-to-manoeuvre for interest rate movements suggests two policy possibilities: raising the inflation target or breaking through the effective lower band. Both possibilities are driven by the realisation that countries might begin the next downturn with the policy interest rate still quite low, with limited room to lower further. It is common to measure this challenge in terms of past peak-to-trough falls in the policy rate[8]. This seems to me to be the wrong measure – the better measure is how far the policy rate can be shifted below the nominal neutral rate. This is the best measure of the stimulative power of the policy setting, not how far the policy rate fell over the course of a cycle.

Setting a higher target seems to be giving away a lot, abandoning not only the Greenspan criterion -- a rate of inflation which does not affecting decisions much -- but also abandoning the painful process that has gone into establishing something around 2% as a sensible number for inflation. Exploring below-zero settings when required may be slightly more acceptable: certainly there is no special magic about the 'zero' number, as we have all experienced zero real rates without the sky falling in. My guess is that it's quite hard to get far below zero nominal: even if you got rid of cash, the financial markets would develop alternative deposit instruments which would fund lending and be beyond the ability of policy to influence. The tentative experience so far suggests that negative rates are mainly about the exchange rate, which some would see as beggar-thy-neighbour policy. Negative interest rates don't seem like a longer-run solution: Paul Samuelson reminded us long ago that there is something abnormal about zero-interest long-run borrowing costs: it would be profitable to flatten the Rockies. If the nominal policy rate needs to be at zero (and negative in real terms) for an extended period of time,

[8] See Cicchetti (2017)

it would be better to ask what has gone wrong with the economy that requires this setting.

But the powerful argument against either of these policies is that the effort to get more room-to-maneuver for the policy instrument is a false objective. The argument made above is that stimulative policy settings below the neutral rate have a trade-off between benefit and harm, and a substantial and sustained margin can do more harm than good.

Judgments on this depend heavily of what the Wicksellian neutral rate is. A common view (especially in the US) is that that the neutral rate has fallen substantially and perhaps permanently (Laubach and Williams (2015))[9]. The counter-argument is that profits have been quite high since 2008, so if we think of the neutral rate as the marginal product of capital (rather than the rate at which current monetary policy would have no influence), then there would be some hope that the neutral rate hasn't fallen much. Maybe the risk premium on investment is high for specific and temporary reasons and in time will revert. If so, the case for this kind of disruptive regime change (especially raising the FIT target) is weak: at least we shouldn't be rushing to change.

One lesson from the GFC experience is that the financial sector should have a larger role in policy-thinking. This is not an entirely new view. It's not that financial stability was ignored (as the universality of financial stability reports demonstrates): it's just that it was intentionally separated from monetary policy, often handed over to prudential supervisors. Even well before 2007, some were trying to link what was happening in the financial sector with monetary policy: running in the background during the FIT regime was a concern about finance, expressed most cogently at the BIS (Borio and Lowe (2002)). This was not so much an alternative to FIT, but an additional objective. 'Lean-or-clean' was part of the pre-2007 debate, but has had more attention since. It reflects the not-very-satisfactory role of asset prices and credit in monetary policy -- hence the consistent effort by Claudio Borio to get these two variables added into the policy-guidance regime. Clearly asset prices are much more volatile than inflation, and if

[9] The econometric work which comes up with very low (even negative) neutral rates seems to be influenced by the long period of post-2007 abnormally low rates (especially when compared with the high real rates that followed the Volcker shock).

they became a specific target for monetary policy, there would be seriously conflicting policy guidance.

Even if the 'lean-or-clean' debate is unresolved, one policy instrument has emerged from the post-GFC debates, which is both a response to the previous neglect of financial sector stability and a panacea: macro-prudential policy. Why is this relevant to the question of alternative monetary targets? Macro-pru has the capacity to address not only financial stability issues, but also to reinforce and correct the apparent weakness of the monetary policy instrument. If higher interest rates aren't reining in excessive demand, then direct limits on borrowing will do the job. If, as I argued above, the GFC was largely caused by prudential failures, this is reason-enough to give macro-pru a bigger role. Of course every policy has its caveats and constraints. This is not the place to give chapter-and-verse on macro-pru. Just two observations. The first is that macro-pru is 'back to the future': this is what we did before financial deregulation and we abandoned it (or it abandoned us) because of the great ability of the financial sector to evolve in order to evade direct controls. Second is that whatever macro-pru might be able to do to support monetary policy and make it more powerful, this benefit won't exactly correspond with the objective of using macro-pru to ensure financial sector stability. During the cyclical upswing when monetary policy might be calling for restraint, bank profits are high and the prudential supervisor has few worries about bank health, so little reason to tighten macro-pru. In the downturn, the prudential supervisor is looking for banks to conserve capital by reining in lending, at the very moment when monetary policy would prefer stimulus for the weakening economy. We can only hope for well-coordinated efforts.

How to draw this wide-ranging discussion together? Monetary policy regimes, like sovereign regimes, don't change when they are working acceptably well: they change when they fail. So has FIT failed?

For me, the answer is a clear 'no'. The two great advantages of FIT framework are:

- it insulates the central bank from political pressure and
- it directly anchors inflation expectations.

Success in maintaining these two advantages depends on FIT's simplicity and clarity: one prime objective and one instrument. To have anything other than inflation as the prime target (e.g. GDP growth) threatens the directness of the anchoring function. Changing the inflation number raises the same issue, now that the 2%-ish target is well established. To add other objectives (a full employment target number; temporary price level) increases complexity of the policy debate, makes decisions harder to explain simply and thus threatens political support. To use other instruments (e.g. QE) has the same problem of putting the beautiful simplicity of FIT at risk.

Instead of abandoning FIT when it doesn't seem to be working perfectly, the better answer is to acknowledge that monetary policy is an imperfect and sometimes weak instrument, overwhelmed by 'headwinds' such as fiscal austerity or balance sheet constraints[10]. When central banks hit the ELB, they should explain that their policy is still working strongly (policy rate is below the natural rate), 'peddle to the metal', and other policy instruments (notably fiscal policy) should be brought to bear. This is the primary lesson of the feeble post-2008 recovery experience, with the recovery undermined by fiscal austerity.

What about the first problem: the absence of a clearly-defined Phillips curve[11]? I said that I regard this as a lesser problem, because I think that what has happened can be well-explained in terms of the expectations-augmented Phillips curve combined with flat short-run curves, thanks to the success of FIT. Why should we fret if this is allowing the US economy to operate with low unemployment, perhaps slowly reversing some of the post-2008 labour-market hysteresis? The right response is to cautiously explore just how far this can be pushed (keeping a weather eye particularly on output and labour-market indices) without triggering an adverse response in price expectations. This might give a larger role to output than in the early versions of IT, but this greater flexibility is now more feasible, with inflation expectations more firmly anchored than when FIT was new.

Meanwhile the main challenge for central banks is elsewhere. Before 2007, monetary policy seemed to be largely separable from the finance sector. Financial markets, balance sheets and asset prices, which were in the distant background in the FIT framework, have been brought centre-stage by the GFC. Where the prudential supervisor is not the central bank, this raises sensitive territorial issues.

[10] For a different view on the power of monetary policy, see Romer and Romer (2015)
[11] See Blanchard (2017(b))

Where there is overlap (for example in the ‘lean or clean’ debate), this has to be finessed, hopefully with a well-coordinated and collegiate relationship between central bank and prudential supervisor.

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