Targets for Monetary Policy After the Global Financial Crisis

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After the Crisis

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  - importance of clear commitment to a low inflation target
  - simple rules of thumb such as "Taylor rule" to conduct policy in accordance

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- After the crisis: how much of that consensus should be reconsidered?

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- Is a commitment to control inflation still helpful when policy is constrained by the interest-rate lower bound?

Issue 1: Policy When Financial Markets Malfunction

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  — though real GDP not yet falling, inflation possibly rising

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- Proof that a sole focus on inflation and aggregate activity is too narrow a perspective?

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- What New Keynesian models imply:
  - inflation and output gap measure important distortions that should be minimized
  - criterion for optimality of policy can be formulated in terms of a relation between paths of inflation, output gap that must hold for optimal balance between competing concerns
  - path of policy rate should be adjusted so as to imply projected paths for inflation, output gap that satisfy this relation ("flexible inflation targeting")

Flexible Inflation Targeting

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  — e.g., real determinants of "natural rate of interest"

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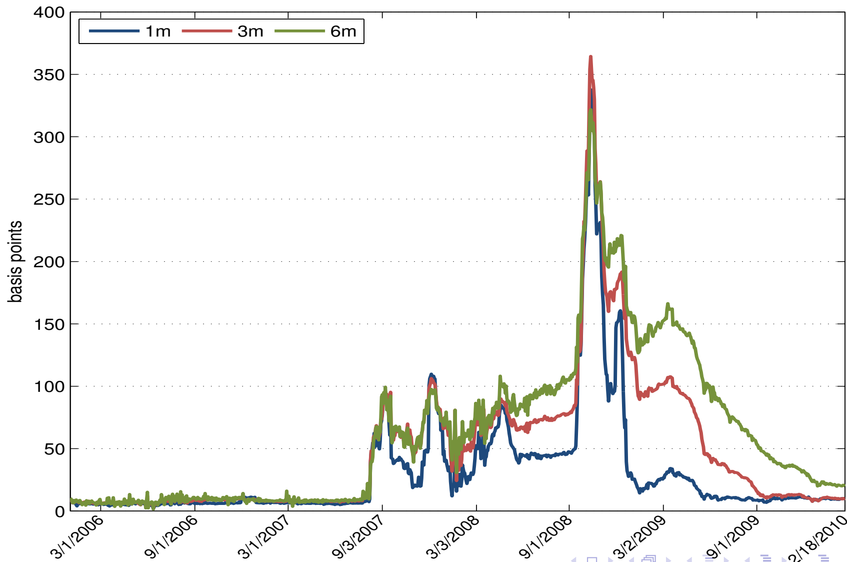
- Evidence of financial market disruption — in particular, anomalous behavior of spreads — indicates that linkages between policy rate and the economy are no longer what they ordinarily are

  — hence required path of policy rate will be different, without any change in target criterion

LIBOR-OIS Spread (US$)



Cúrdia-Woodford (2009)

- Illustrates that the problem when credit markets are disrupted is not necessarily a need for a target criterion different from the standard one
  - quantitative DSGE model which introduces credit frictions into otherwise standard New Keynesian model
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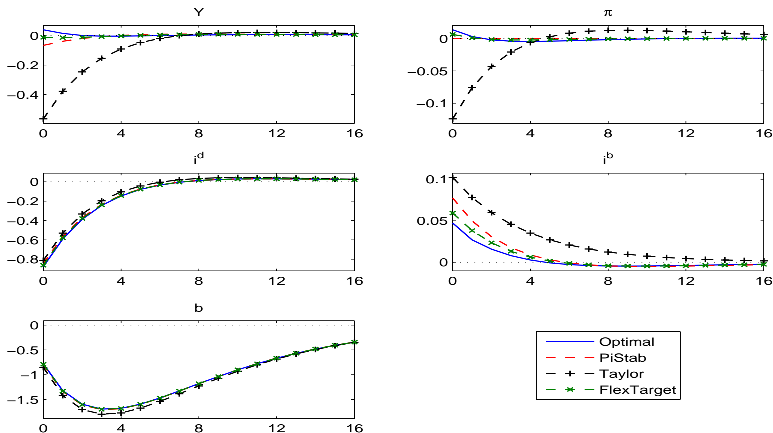
- Monetary policies to compare:
    - welfare-optimal policy commitment
    - Taylor rule
    - commitment to a target criterion of form

$$\pi_t + \phi \Delta x_t = \pi^*$$

Numerical Results: Alternative Policy Rules



Responses to financial shock, under alternative monetary policies

Simple Proposal: Nominal GDP Targeting

- Numerical results in Cúrdia-Woodford model also indicate that the exact value of ϕ in the target criterion is not too crucial, for this type of disturbance
- A case where the target criterion is relatively easy to explain: $\phi = 1$, in which case it can equivalently be written as

$$\Delta(p_t + y_t) = \pi^* + \Delta y_t^*$$

— a form of nominal GDP target, intended to be consistent with the desired medium-run inflation rate π^*

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- Conventional guidelines such as "Taylor rule" cease to be useful
  - and CBs look for alternative means through which to provide further stimulus

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- But the real rate floor is only high if low expected inflation
  - no coincidence that lower bound problems have arisen only in period with widespread commitments to low inflation
  - does this mean inflation targets too low? (Summers, Blanchard)
  - or at least that inflation target should be temporarily suspended if one hits the interest-rate lower bound? (Krugman)

Would a Commitment to Inflationary Policy Help?

- In standard models, yes (Eggertsson-Woodford, 2003)
  - higher expected inflation makes real rate lower, stimulating current spending
  - reduced fear of premature policy tightening also lowers expected future path of short rates, reducing long rates and depreciating exchange rate
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- Of course, this depends on successfully changing expectations

  — might be more effective if words accompanied by current actions consistent with the commitment to reflation

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- Calculations of optimal policy commitments in New Keynesian models (Eggertsson-W, Werning 2011):
  - commitment to maintain low rates for a period, even after achievement of conventional targets would again be possible
  - allows brief inflationary boom
  - but commitment to rapid return to price stability thereafter

Does It Mean Suspension of Usual Rules?

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- But this raises questions:
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  - should anyone believe that the suspension of former inflation target isn't permanent?

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- A superior approach: commitment to reflation as part of a consistent approach that applies when ZLB binds, and when it doesn't

A Targeting Framework

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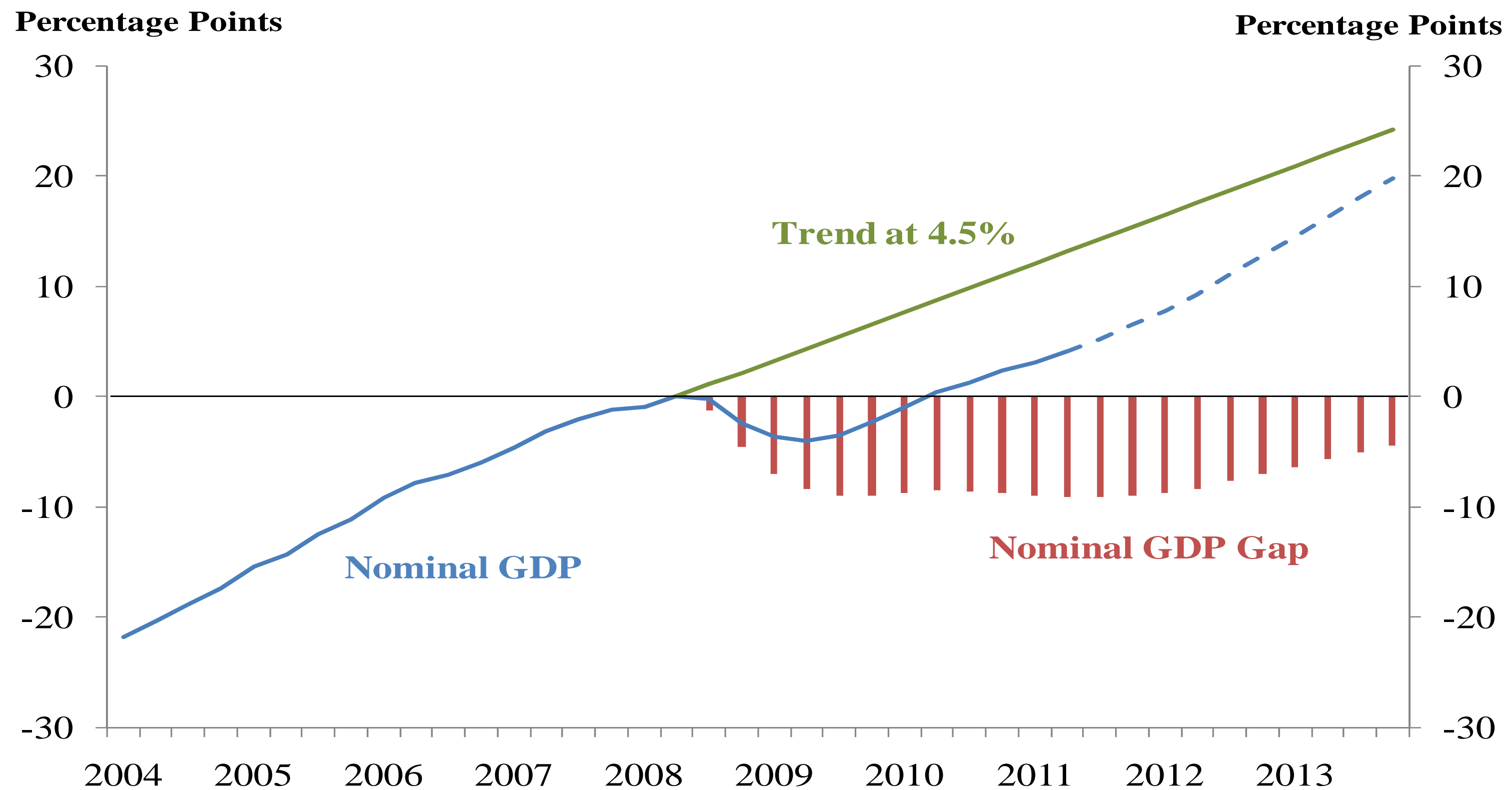
  - if undershoot due to ZLB, appropriate to aim for higher than usual nominal growth rate, until "nominal GDP gap" is closed
  - automatically implies should not expect policy tightening soon
  - but also allows confidence that resulting inflation will be bounded

A Nominal GDP Target Path for US



- *Growth of nominal GDP increases from about 4.5% to about 6.5%, cutting the gap in half by the end of 2013*

Conclusion

- CBs have faced many extraordinary challenges as a result of the cris[es]
- simple formulas inadequate in such complex circumstances: must instead return to principles underlying them
- but not obvious that there needs to be a change in basic goals of monetary policy

Conclusion

- Important for dealing well with the particular kinds of challenges just discussed:
  - commitment to a target criterion, rather than to a pre-specified list of variables to be used as indicators
  - commitment to error-correction, rather than to a purely forward-looking target that "lets bygones be bygones"