Targets for Monetary Policy
After the Global Financial Crisis

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12th Annual Neemrana Conference, December 2011
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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?
Two Questions

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

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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**
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
  - consider the effects of a disturbance to the severity of credit frictions, under alternative assumptions about monetary policy

Monetary policies to compare:
- welfare-optimal policy commitment
- Taylor rule
- commitment to a target criterion of form
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Responses to financial shock, under alternative monetary policies
Numerical results in Cúrdia-Woodford model also indicate that the exact value of $\phi$ 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 $\pi^*$.
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Issue 2: The Interest-Rate Lower Bound

- An important change in the conduct of monetary policy by the Fed (and many other CBs) in 2009-2010: short-term interest rate targets reached effective lower bound, below which CBs were unwilling to push them.

- 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
  - anticipation of looser future policy also increases income expectations, encouraging current spending

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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Should Inflation Targets Be Higher?

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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:
  - Are any commitments about future policy really meaningful?
  - 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
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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
A Targeting Framework

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  - 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 crises.

- 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”